Parliamentary Budget Office

PARLIAMENT OF THE REPUBLIC OF SOUTH AFRICA

Quarterly Economic Brief

July 2017

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This report incorporates data available up to and including the 26 July 2017.

Overview

South Africa's economic challenges worsened in the first quarter of 2017 as the economy entered a technical recession, and its foreign-currency credit-rating was downgraded to sub-investment grade. The poor performance was driven by contracting household and government spending. Continued slow investment and economic growth has resulted in unemployment climbing to a 13 year high of 27.7 per cent. Economic growth over the medium term, constrained by weak household spending, low investment and the effects of fiscal consolidation, is expected to be poorer than expected at the beginning of the year, implying fiscal projections presented in the Budget Review in February will not be realised.

Gross domestic product

The South African economy entered a technical recession – defined as two consecutive quarters of contracting growth – in the first quarter of 2017. The economy contracted by 0.7 per cent compared to the previous quarter on a seasonally adjusted and annualised basis. This follows the 0.3 per cent contraction recorded for the fourth quarter of 2016. Compared with the same quarter of 2016, the economy contracted in the first quarter of 2017 by a substantial 1.2 per cent.

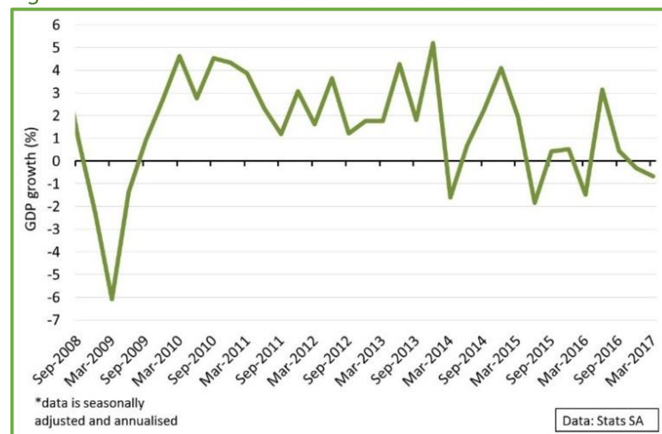
Table 1: Most sectors contracted over the quarter

% change q/q	Agriculture	Mining	Manufacturing	Utilities	Construction	Trade	Logistics	Business services	Government	Personal services	GDP
1Q2017	22.2	12.8	-3.7	-4.8	-1.3	-5.9	-1.6	-1.2	-0.6	-0.1	-0.7
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
2Q2016	-7.8	14.6	7.6	-3.2	0.1	1.6	2.2	2.4	1.3	1.8	3.1

Data: Stats SA

Over the quarter, eight out of the ten sectors contracted. The trade sector, which comprises about 14 per cent of GDP, contracted by a large 5.9 per cent, subtracting 0.8 percentage points from the quarter's overall growth. The sector, which includes wholesale, retail and hospitality trade, was affected by weak household spending. The manufacturing sector contracted by 3.7 per cent – its third consecutive contraction. This contraction in manufacturing value-added during the first quarter of 2017 subtracted 0.5 percentage points from the quarter's overall year-on-year growth rate.

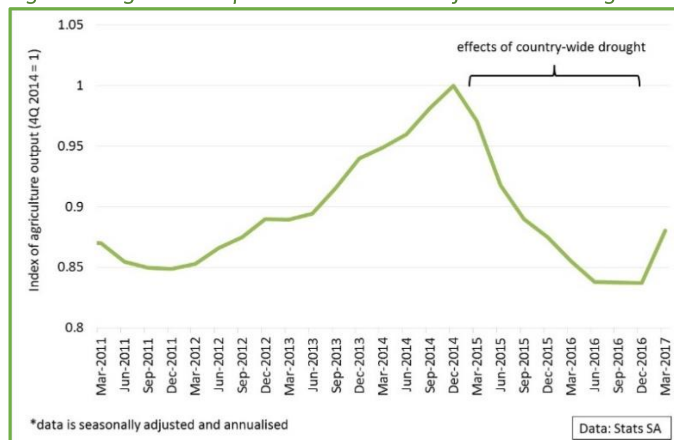
Figure 1: First technical recession since 2008-2009



The agriculture, forestry and fishing (AFF) sector and the mining and quarrying sectors were the only economic sectors that recorded positive growth over the quarter. The agriculture sector, recorded positive growth for the first time in 24 months, as one of the worst droughts in recent history appears to have ended. The sector grew by a significant 22.2 per cent, reflecting an overall recovery led by increased field crop production, and improved rainfall. The Crop Estimation Committee of the

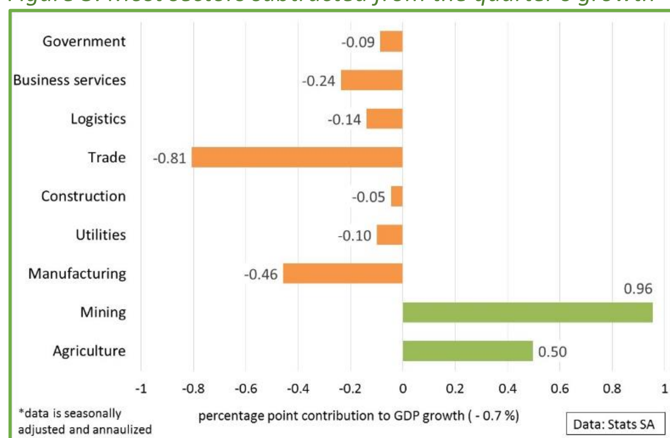
Department of Agriculture Forestry and Fisheries expects the maize harvest for 2016/17 to be the highest on record.

Figure 2: Agriculture production recovers from the drought



The mining sector grew by 12.8 per cent following the contraction of 11.5 per cent in the previous quarter. The improved performance was due to an increase in the production of iron ore and platinum group metals, which were supported by an overall increase in international commodity prices.

Figure 3: Most sectors subtracted from the quarter's growth



Box 1: Recession and public finances

Slowing economic growth, particularly an economic recession, implies slow growth in employment opportunities, and lower revenue growth. South Africa has struggled with sustained high unemployment, and revenue buoyancies – the change in revenue relative to the change in economic growth – have been falling.

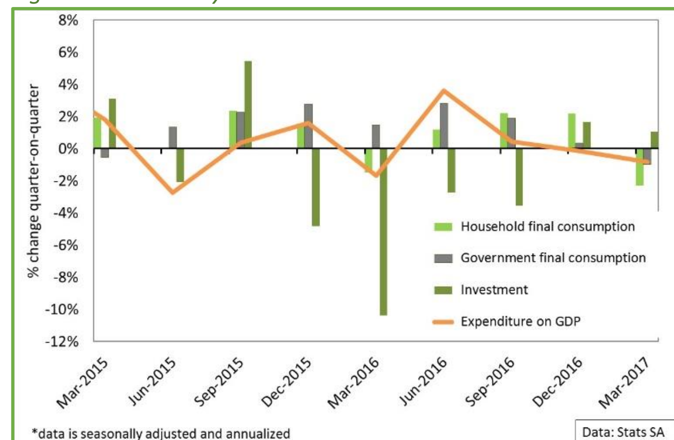
At the time of the previous recession, government stimulated the economy through the use of fiscal policy, supported by a more accommodative monetary policy stance by the SARB. National debt in 2008/9 was 21.8 per cent of GDP and government chose to issue more debt to increase public expenditure and investment.

The country's current fiscal and monetary space seems considerably lower compared to 2008/09 as net national debt increased to over 46 per cent of GDP in 2016/17 and is expected to reach 47 per cent in 2017/18. Government introduced non-interest expenditure ceilings in 2012. The objective of introducing expenditure ceilings was to stabilise debt as a share of GDP over the medium term. However, the ceilings limit government's ability to stimulate the economy.

Expenditure on GDP[1]

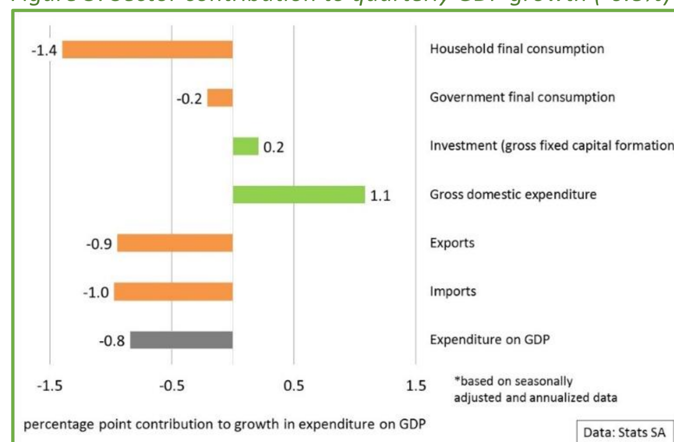
Measured from the expenditure side, the economy contracted by 0.8 per cent in the first quarter of 2017 compared to the previous quarter. This follows the 0.1 per cent contraction recorded for the final quarter of 2016. The poor performance over the quarter reflected depressed domestic demand led by a weaker consumer position, lower consumer and investor confidence, and the effects of fiscal consolidation.

Figure 4: Growth by sector



Over the quarter household consumption contracted by 2.3 per cent – its first contraction since 2007. Growth in household consumption, which comprises over 60 per cent of GDP, subtracted 1.4 percentage points from the quarter's economic growth. The contraction in household consumption expenditure is in part due to lower household income, lower employment levels, the continued slowing of credit extended to households, and the effects of higher personal income tax.

Figure 5: Sector contribution to quarterly GDP growth (-0.8%)



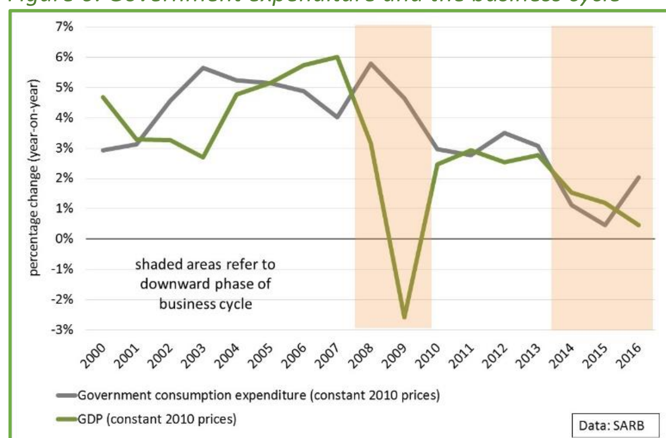
Real average remuneration per worker in the economy decreased by 0.2 per cent over 2016 – its first decrease since 2007. In addition to the decline in average real compensation, the number of people employed across the economy also decreased. The Quarterly Employment Survey for the first quarter of 2017 showed that the number of people employed in formal non-agricultural sector firms decreased by 48 000 (0.6%) when compared with the same quarter in 2016. The Quarterly Labour Force Survey for the first quarter of 2017 estimated the country's official (or narrow) employment rate

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

to be at a 13-year high of 27.7 per cent. Lower compensation and lower employment levels are likely to have contributed to the contraction in household consumption, as well as lower growth in Personal Income Tax receipts for the quarter. Personal Income Tax for the first quarter of 2017 grew by only 9.4 per cent compared to its 5-year average of 11.2 per cent. This occurred despite the increase in personal income tax rates proposed in the 2016 Budget and limited fiscal-drag relief. Continued poor average real wage growth and poor employment growth, combined with revenue raising measures – to assist government to meet its fiscal objective – would probably further dampen future household expenditure and economic growth.

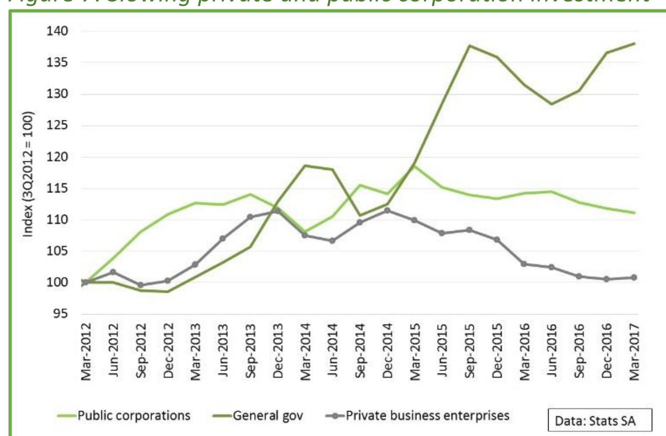
Over the quarter, government expenditure contracted by 1 per cent – its first quarterly contraction since 2015. The contraction subtracted 0.2 percentage points from the quarter's economic growth. The slowdown in government expenditure was partially due to its efforts to reduce the primary deficit, and 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 6: Government expenditure and the business cycle



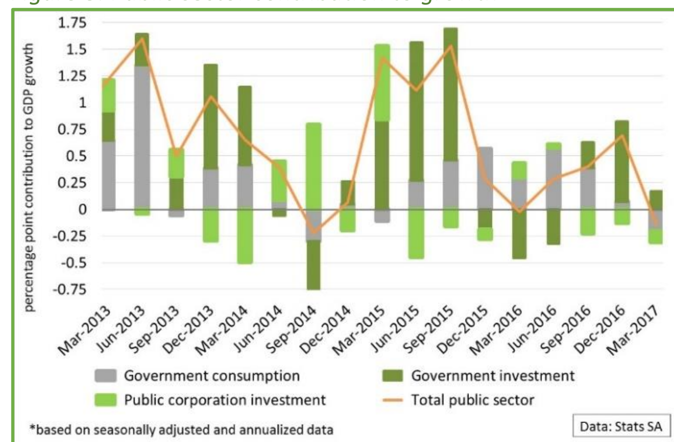
Since the introduction of the non-interest expenditure ceiling in 2012, government's fiscal policy stance – indicated by the real growth in final government expenditure relative to economic growth – has become weakly counter-cyclical, as government expenditure slowed along with economic growth. Further reductions to the expenditure ceiling – as has been the case in recent budgets – along with less-optimal shifts within the current expenditure envelope may further reduce government's direct contribution to economic growth.

Figure 7: Slowing private and public corporation investment



Over the quarter, total investment (gross fixed capital formation) in the economy grew by 1 per cent, building on the growth of 2 per cent recorded for the last quarter of 2016. The growth in investment added 0.2 percentage points to the quarter's economic growth. Private investment grew by 1.2 per cent, after contracting over the previous five quarters. Investment by public corporations contracted by 2.7 per cent – its third consecutive quarterly contraction. The contraction in public corporation investment subtracted 0.1 per cent from the quarter's growth.

Figure 8: Public sector contribution to growth



Slowing growth in government consumption expenditure and investment, as well as public corporation investment has reduced the public sector's contribution to growth. Slower economic growth, increasing debt and borrowing costs, and weaker balance sheets have further limited the public sector's ability to support economic growth. The last time South Africa experienced a recession, public debt was lower, while interest rates were higher, allowing government fiscal and monetary space to stimulate the economy.

Employment

The official unemployment rate reached a 13-year high in the first 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 one percentage point from the first quarter of 2016. The labour force grew by 4.8 per cent (1 025 587) over the year, exceeding the growth in the number of people employed (3.4 per cent – 537 737), resulting in an increase in the unemployment rate.

The broad unemployment rate, which includes discouraged job-seekers, is estimated at 36.4 per cent, marginally higher than a year ago. Broadly defined, the number of people unemployed increased by about 374 000. Youth unemployment, officially defined, increased by 0.9 per cent over the year to 38.6 per cent. Broadly measured, the youth unemployment rate is 48.8 per cent.

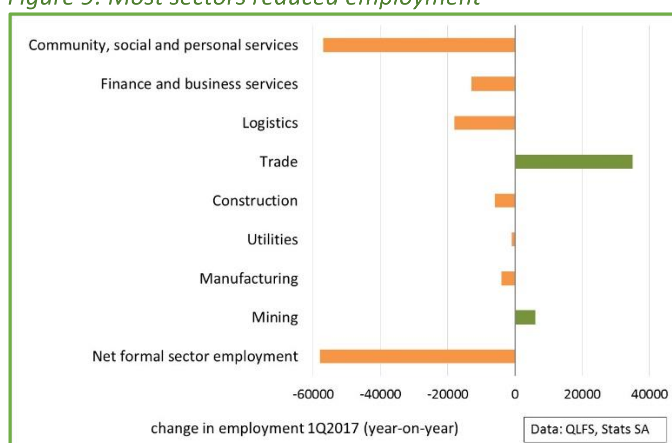
Increasing levels of unemployment is associated with higher dependency on government social grants. Although South Africa does not have an unemployment grant, households have become increasingly dependent on social grants. Since 2009 the portion of households stating social grants as the main source of income has increased from 15 per cent to over 20 per cent.

Table 2: Key labour statistics – Quarterly Labour Force Survey

	1Q 2016	4Q 2016	1Q 2017
Labour force ('000s)	**21 398**	**21 849**	**22 426**
Employed	15 675	16 069	16 212
Unemployed - official	05 723	05 781	06 214
Unemployed - broad*	08 916	08 900	09 291
Not economically active ('000s)	**15 033**	**15 055**	**14 634**
Discouraged job-seekers	02 434	02 292	02 277
Other (not economically active)	12 599	12 763	12 357
Rates			
Official unemployment rate (narrow)	26.7%	26.5%	27.7%
Broad unemployment rate*	36.3%	35.6%	36.4%
Youth unemployment** (narrow)	37.7%	37.1%	38.6%
Youth unemployment** (broad*)	48.8%	47.7%	48.8%

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

Figure 9: Most sectors reduced 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 shed 58 000 formal non-agricultural jobs over the year. Only the trade and mining sectors added jobs.

Significant job losses were recorded for the logistics sector (18 000), finance and business services sector (13 000), and community, social and personal services sector (57 000). As the average remuneration per employee for these sectors exceeds the national average, there may be significant negative consequences for overall household consumption, and personal income tax receipts from lower overall employment.

Current account

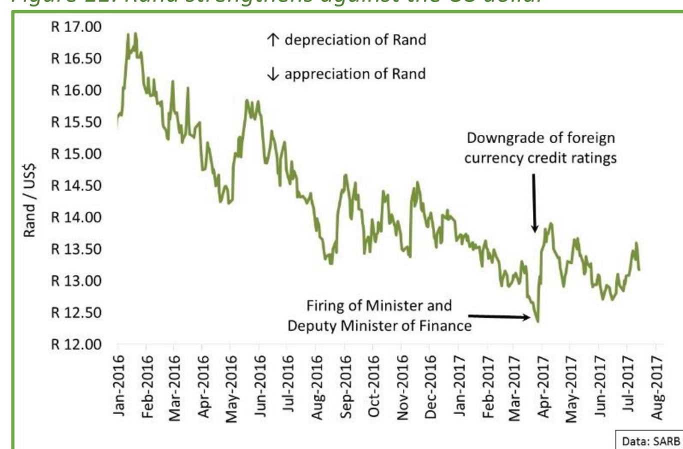
South Africa's current account deficit increased slightly during the first quarter of 2017 to 2.1 per cent of GDP (R92 bn on a seasonally adjusted and annualised basis) from the 1.7 per cent recorded in the fourth quarter of 2016. The increase in the current account deficit was due to a larger shortfall on the service, income and current transfer account, which increased from R132 bn to R149 bn. The trade balance remained in surplus (R56bn – 1.3 % of GDP), largely unchanged from the previous quarter, as the increase in exports (R3.4bn) compensated for the increase in imports (R1.7bn). The larger current account deficit means that South Africa remains dependent on savings from the rest of the world. In recent years the current account shortfall has been financed by portfolio flows, particularly foreign purchases of government bonds. This has increased the vulnerability of the rand to the sale of government bonds held by foreigners. A sell-off may arise from a downgrade to the credit-ratings of the country's domestic debt or a tightening of advanced economy monetary policy.

Figure 10: Current account and trade balance

Exchange rate

The rand has strengthened since the beginning of the year, supported by a favourable global economic backdrop, and despite unfavourable domestic political developments. The rand strengthened 4 per cent against the US dollar since the beginning of the year, and 12.9 per cent since the beginning of 2016. Global economic developments supporting the rand include stronger commodity prices, sustained demand for emerging market assets due to continued liquidity, stronger global growth, and uncertainty over the US Federal Reserve's rate hike trajectory. Domestically, the smaller current account deficit, largely due to a decrease in imports, also contributed to a stronger currency.

Figure 11: Rand strengthens against the US dollar



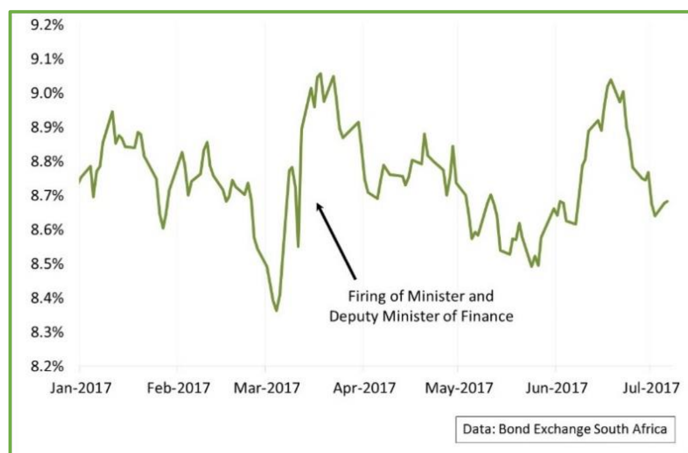
Whilst the rand strengthened together with other emerging market currencies, the rand has been particularly volatile, trading within a wider range. This, in part, reflects volatility in global financial markets and unfavourable domestic political developments, including the cabinet reshuffle in March, and concerns about the country's ability to meet its fiscal targets. Whilst the downgrade of the country's foreign currency credit ratings to non-investment status did not have an immediate

negative impact on the rand, a downgrade to the country's local currency credit ratings is likely to have a large and immediate negative effect.

Sovereign risk

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 six months of the year, falling by 9 basis points to 8.89 per cent. The improvement in SA government bond yields reflects 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.

Figure 12: Yield on SA 10-year bond



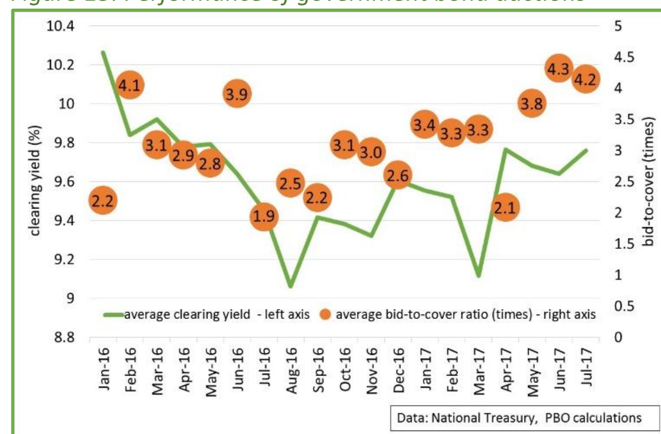
South Africa's sovereign credit ratings – an assessment by the credit rating agencies of the likelihood that the country will default on its debt obligations – have been downwardly revised (indicating higher risk) since 2012 amidst concerns over the country's slowing economic growth and increasing debt. The impact of the country's foreign-currency credit ratings being recently downgraded to non-investment grade did not have a large impact on sentiment in global financial markets. This is, in part, due to the market having already priced-in a foreign currency rating downgrade, reflected in South African credit-default swaps being comparable to other countries currently rated sub-investment grade, as well as foreign-currency debt only comprising a small share of government debt issued.

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	

At present the country's local-currency credit rating is rated just above sub-investment grade. A downgrade by 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. The loss of investment status on local-currency debt may have strong adverse 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. As most funds attempt to track bond indices, the exclusion of South African government bonds from these indices would result in a significant share of foreign bond holders selling-off South African local-currency bonds. As about 40 per cent of local-currency debt is owned by foreigners, a downgrade of local-currency debt to sub-investment grade would significantly increase borrowing costs and weaken the currency. Debt that needs to be issued under such circumstances would likely be more expensive than budgeted for in the 2017 Budget.

Figure 13: Performance of government bond auctions



The results from government bond auctions for the first six months of the year, showed a lower average clearing yield compared to the first six 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 six months of 2016. Clearing yields on government's 20 year fixed rate bonds were on average 32 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.

Inflation and monetary policy

Headline inflation – as measured by the consumer price index (CPI) for all urban areas – fell below the upper bound of the South African Reserve Bank's (SARB) 3 to 6 per cent target range in April 2017 - the first time since December 2015. The sustained decrease in inflation since April is due to lower food price inflation, a stronger rand and depressed demand pressures. Food price inflation has fallen to single-digits since the beginning of the second quarter, as the agriculture sector recovers from the severe drought which had pushed up food price inflation to over 12 per cent. The Crop Estimates Committee of the Department of Agriculture, Forestry and Fisheries expects a marked increase in crop yields, which will put further downward pressure on food and headline inflation.

After keeping the repo rate fixed at its January, March and May meetings, the Monetary Policy Committee decreased the repo rate by 25 basis points in its July meeting. The Monetary Policy Committee cited the improved inflation outlook and the deteriorating growth outlook among the reasons for its decision.

Figure 14: Inflation falls within target range

Outlook

Since the tabling of the National Budget in February, most analysts have downwardly-revised their growth forecasts for the South African economy. Weak investment, slowing household consumption, and the effects of fiscal consolidation are expected to continue to weigh-down domestic economic activity. Despite the economy having entered a technical recession in the first quarter of 2017, it is expected to record modest positive growth for 2017, supported by a strong recovery in the agricultural sector, firm commodity prices, and a lower interest rate.

Table 4: Most analysts downwardly 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%
South African Reserve Bank - July 2017	0.5% ↓	1.2% ↓	1.5% ↓
Bureau for Economic Research - 1Q 2017	1.0%	1.8%	2.3%
Bureau for Economic Research - 2Q 2017	0.3% ↓	0.9% ↓	-
World Bank - January 2017	1.1%	1.8%	1.8%
World Bank - June 2017	0.6% ↓	1.1% ↓	2.0% ↑
International Monetary Fund - January 2017	0.8%	1.6%	-
International Monetary Fund - July 2017	1.0% ↑	1.2% ↓	-
Reuters econometer (median) - March 2017	1.0%	1.7%	2.0%
Reuters econometer (median) - July 2017	0.7% ↓	1.2% ↓	1.5% ↓

The deteriorating growth outlook, softer GDP inflation, and the consequent weak revenue collection-to-date, imply that fiscal projections presented in February's Budget Review may not be realised. Based on the updated growth forecasts and assumptions, the PBO estimates larger budget deficits over 2017/18 and 2018/19 compared government's projections presented in the 2017 Budget Review. The PBO also estimates a higher debt-to-gdp ratio over 2017/18 and 2018/19 compared with government's projections.

Table 5: Key assumptions informing PBO fiscal projections

	2017/18	2018/19
Real GDP growth	0.3%	1.1%
GDP inflation	5.7%	5.6%
Revenue Buoyancy	1.4	1.16

Figure 15: Lower growth outlook implies a larger budget deficit

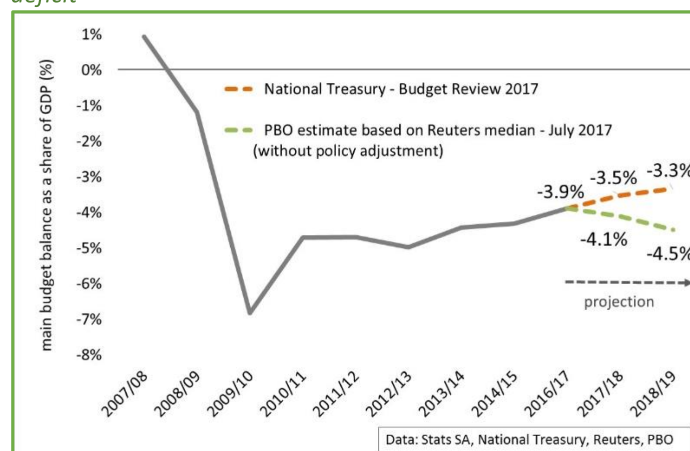
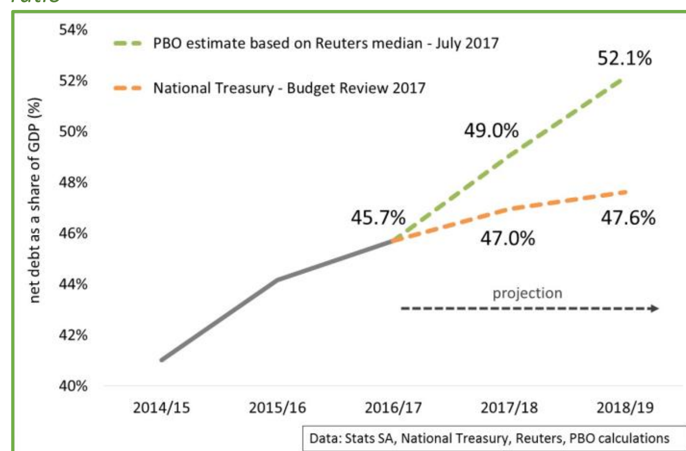


Figure 16: Lower growth outlook implies higher debt-to-gdp ratio



It is important to note that these projections assume that government will take no remedial measures to increase revenue and/or decrease the expenditure ceiling so as to realise its fiscal objective of stabilising debt as a share of GDP over the medium term. Government and parliament should carefully consider future proposals to increase revenue and/or reduce growth in expenditure because of the potential negative consequences on economic growth and service delivery.