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Economic Review and Outlook 2016

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May 2016

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South Africa faced more than its fair share of headwinds in 2015

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Xenophobic attacks



Load shedding



#FeesMustFall



Finance minister fiasco



Drought



New visa regulations starts to bite

China stumbles

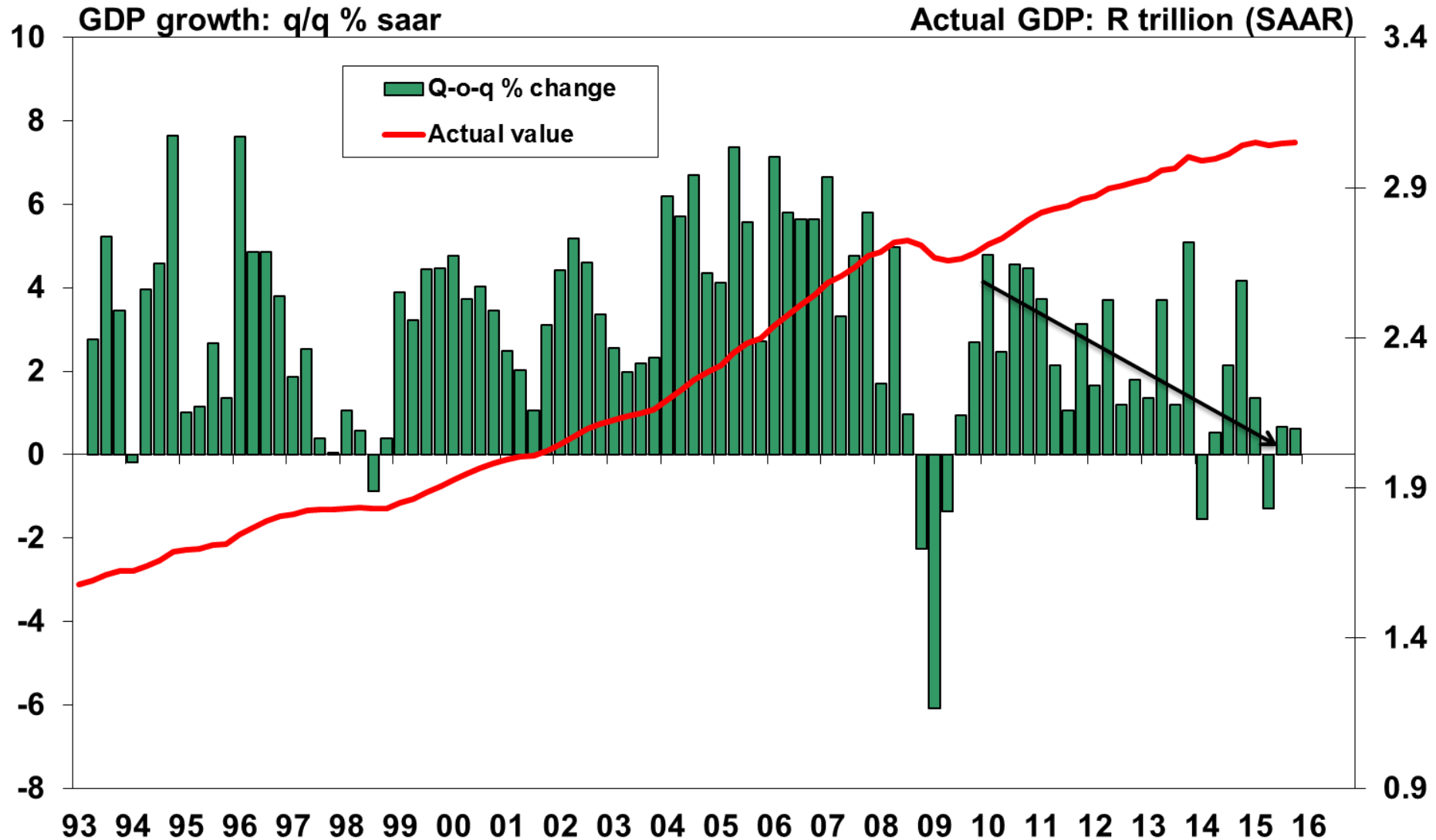


#ZumaMustFall



But fundamentally the economy remains weak and vulnerable – growing by less than 1.5% in 2015

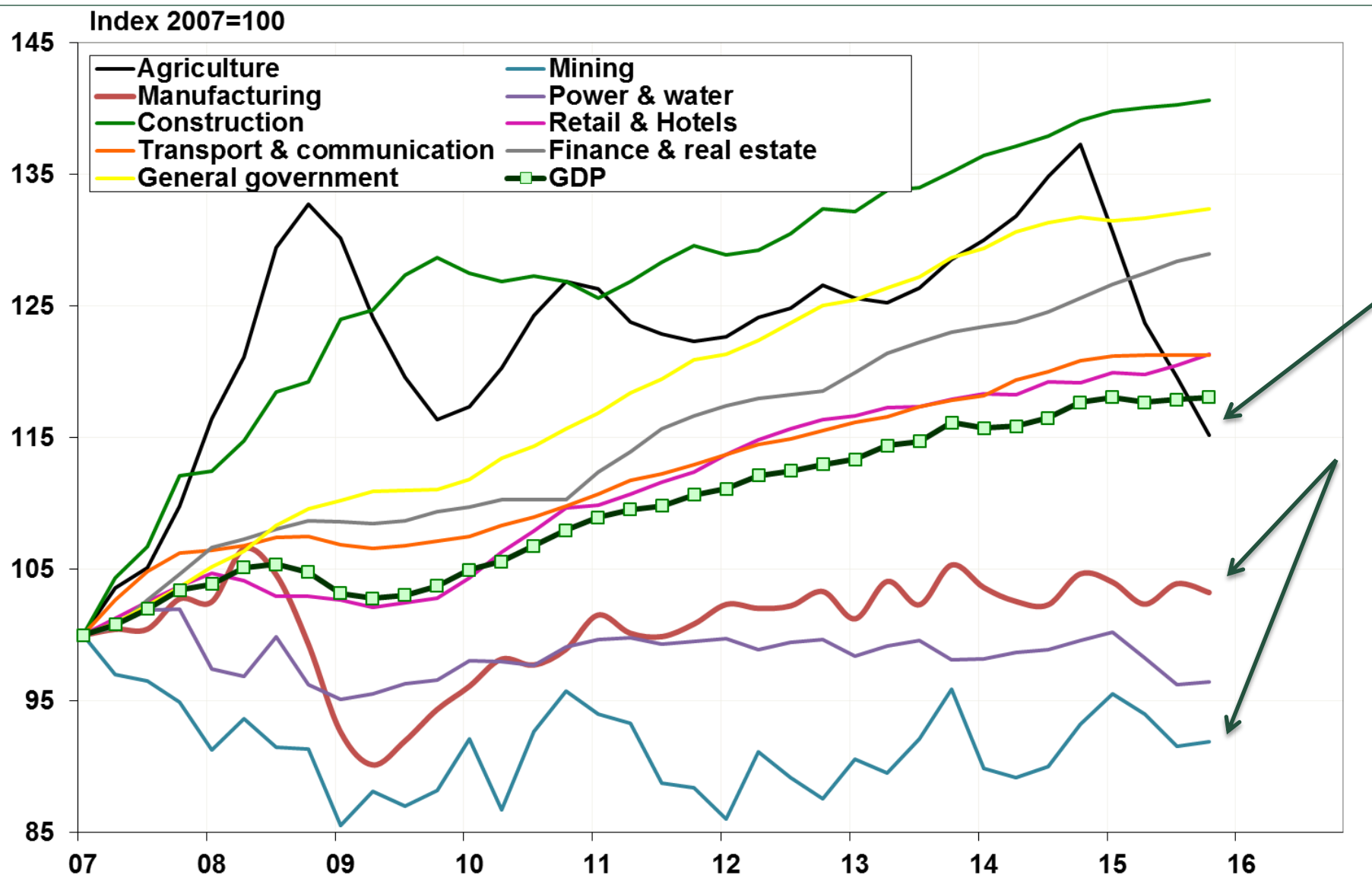
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Source: Stats SA & Nedbank calculations

In 2015 the drag came from weak to shrinking output in the mining, manufacturing and agricultural sectors

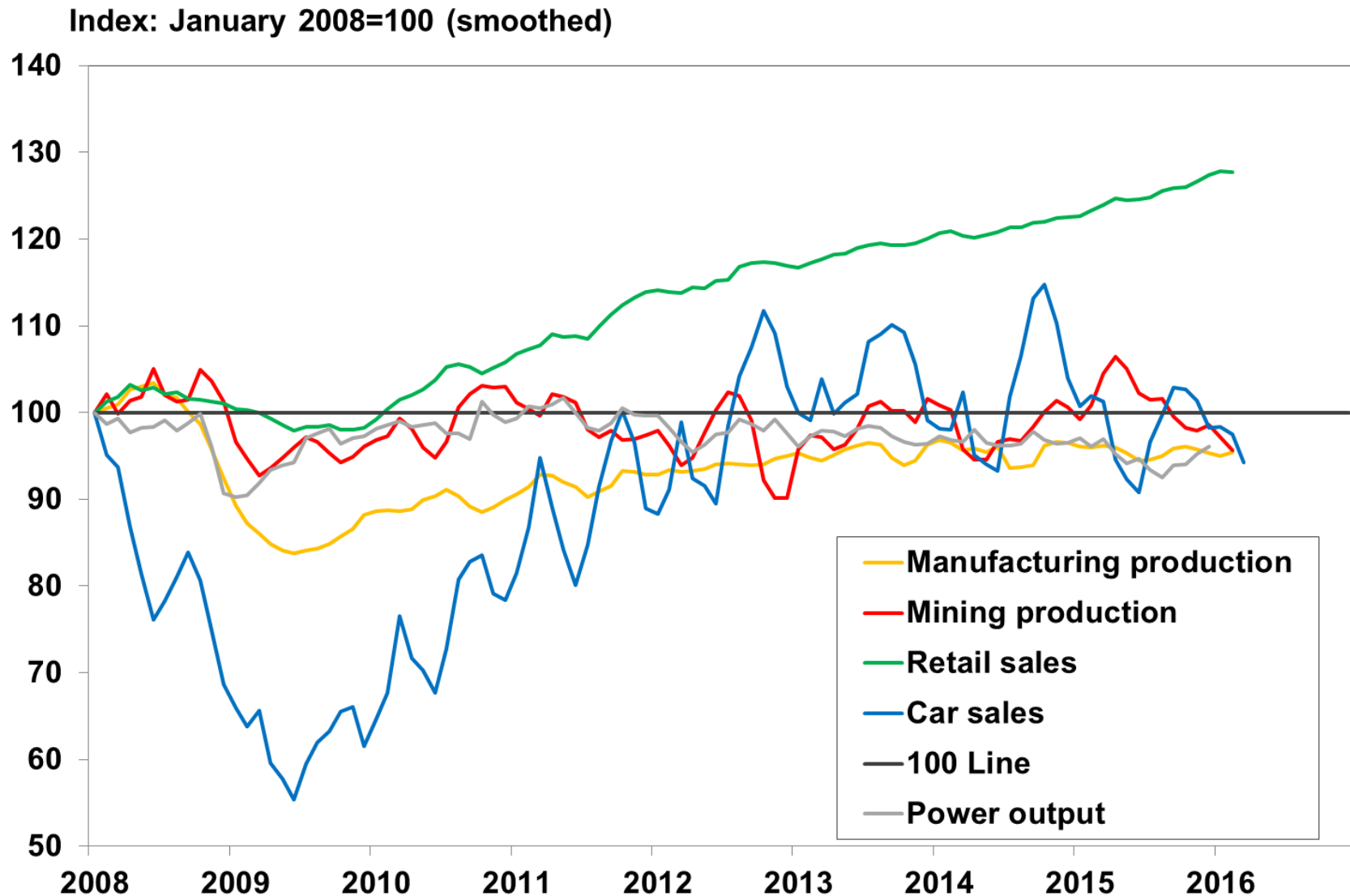
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Source: Stats SA

In early 2016 not much has changed

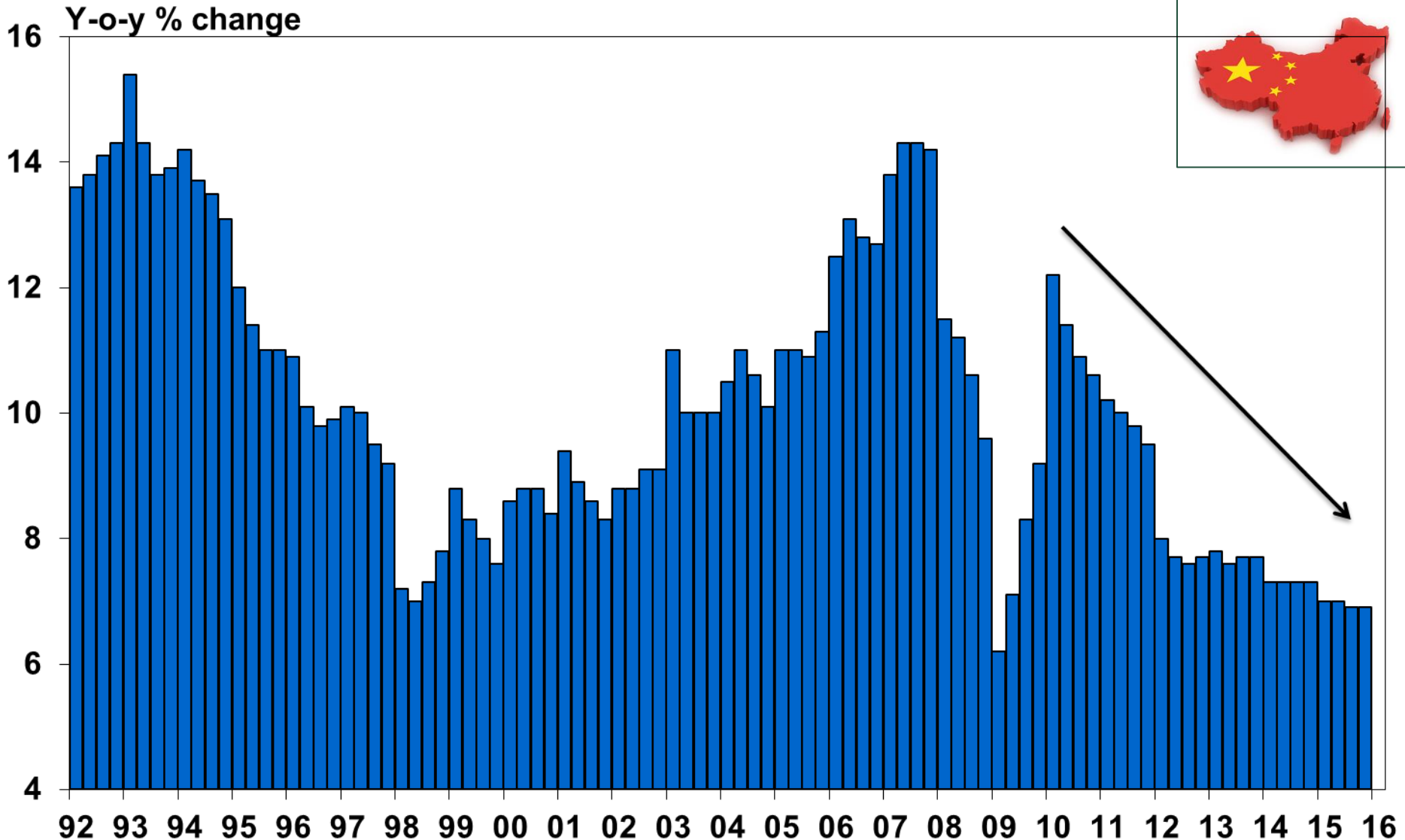
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Source: Stats SA & Nedbank calculations

Mining and large parts of manufacturing are feeling the pain caused by slower growth in China

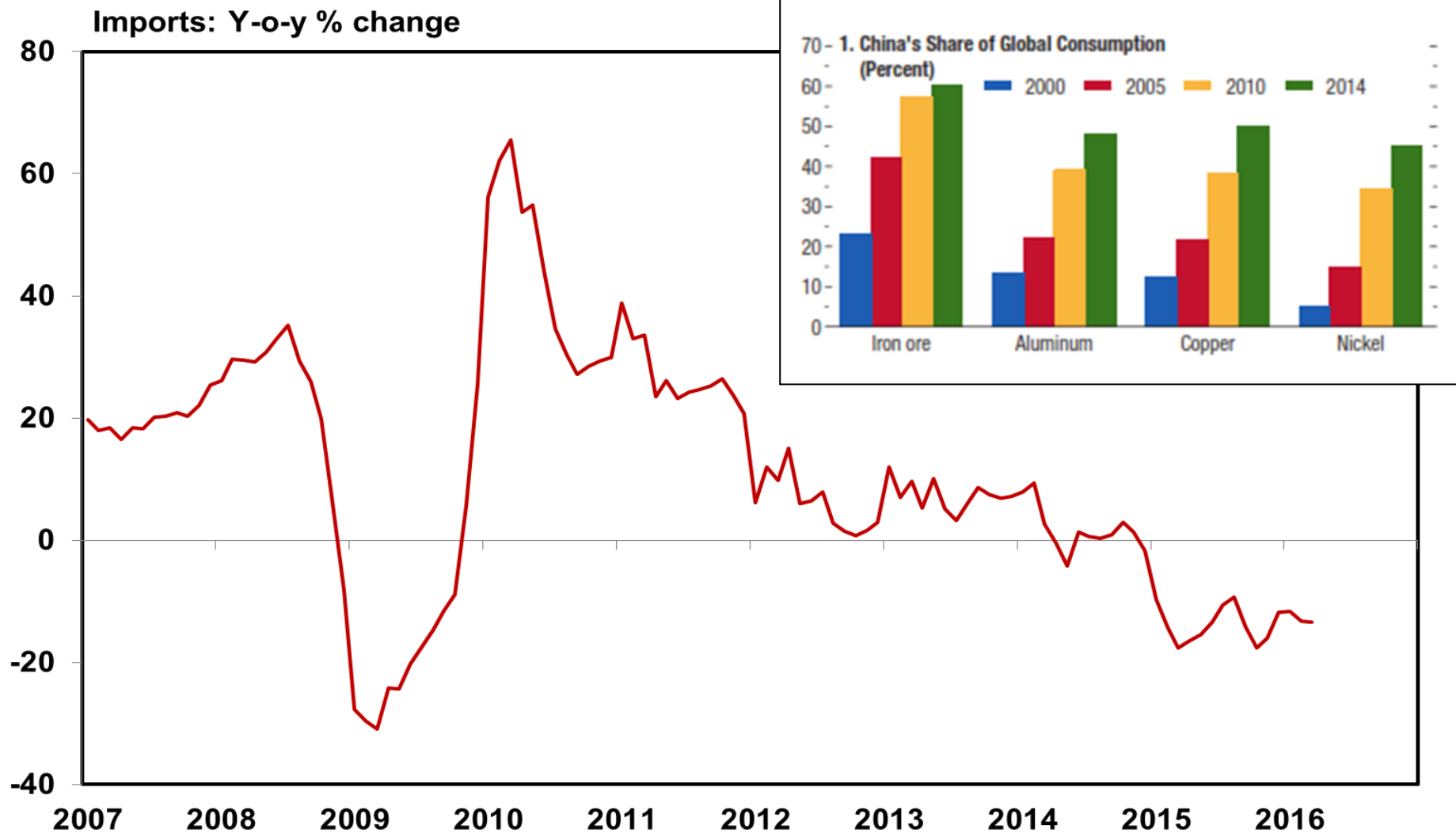
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Source: Reuters Thompson Datastream

Falling Chinese imports have hurt global growth, particularly demand for commodities

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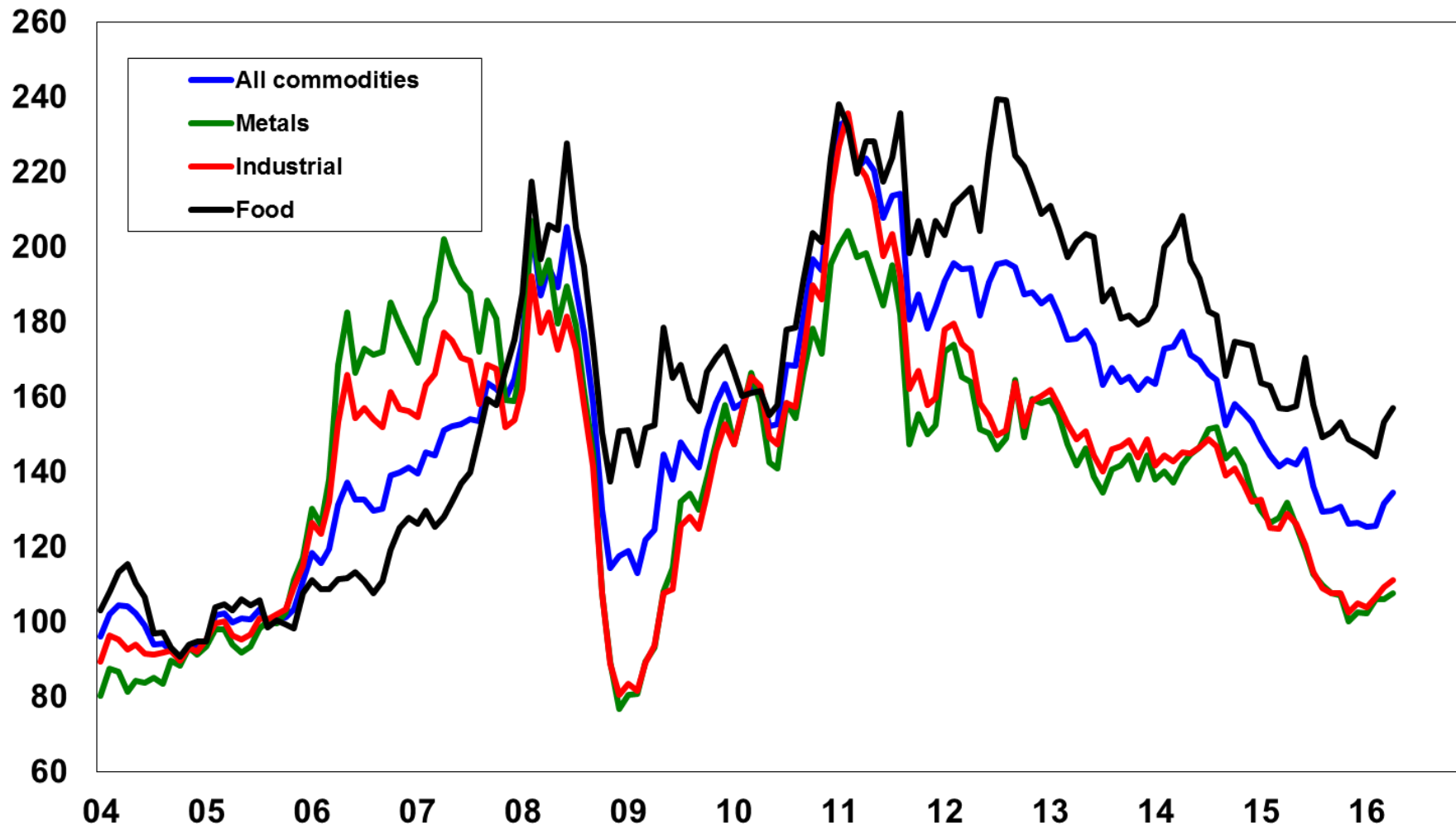
Source: Reuters Thompson Datastream

The recent bounce in global commodity prices may prove short-lived

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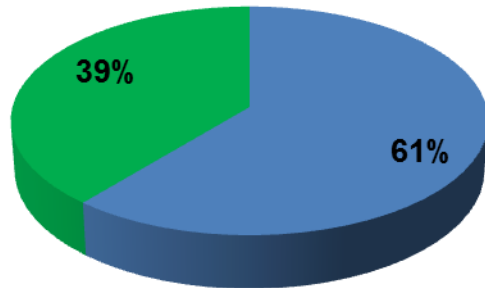
Economist commodity indices in US\$: 2005=100



Source: Stats SA & Nedbank calculations

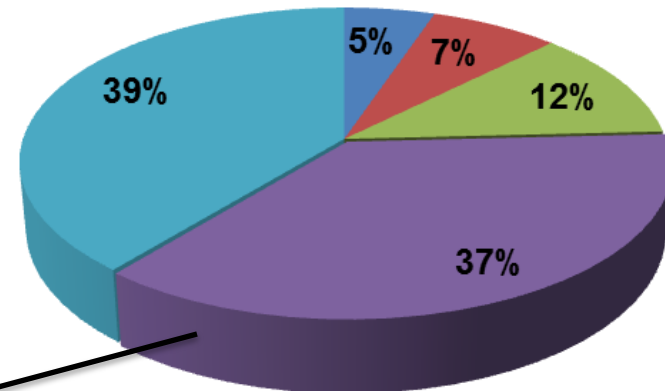
How exposed is South Africa?

Breakdown of SA exports



■ Commodity-related ■ Other

Breakdown of commodity exports



■ Agriculture ■ Chemicals
■ Basic metals ■ Mining

4 commodities feature strongly

	% of total exports
Coal	6.8
Gold	6.0
Iron ore	8.1
Platinum	14.1
	35.0

Source: Customs & Excise

SA is made even more vulnerable by numerous competitive challenges and structural constraints

■ Mounting cost pressures and erosion of global cost competitiveness

- Negative relationship between cost and productivity of labour
- Surging costs of utilities and basic economic services – power, transport (road, rail, ports), water, telecommunications

■ Capacity constraints amplifying costs pressures & constraining expansion

- Lack of power generating capacity
- Limited and ageing road, rail and port infrastructure
- Insufficient social infrastructure – public transport, health, education, water

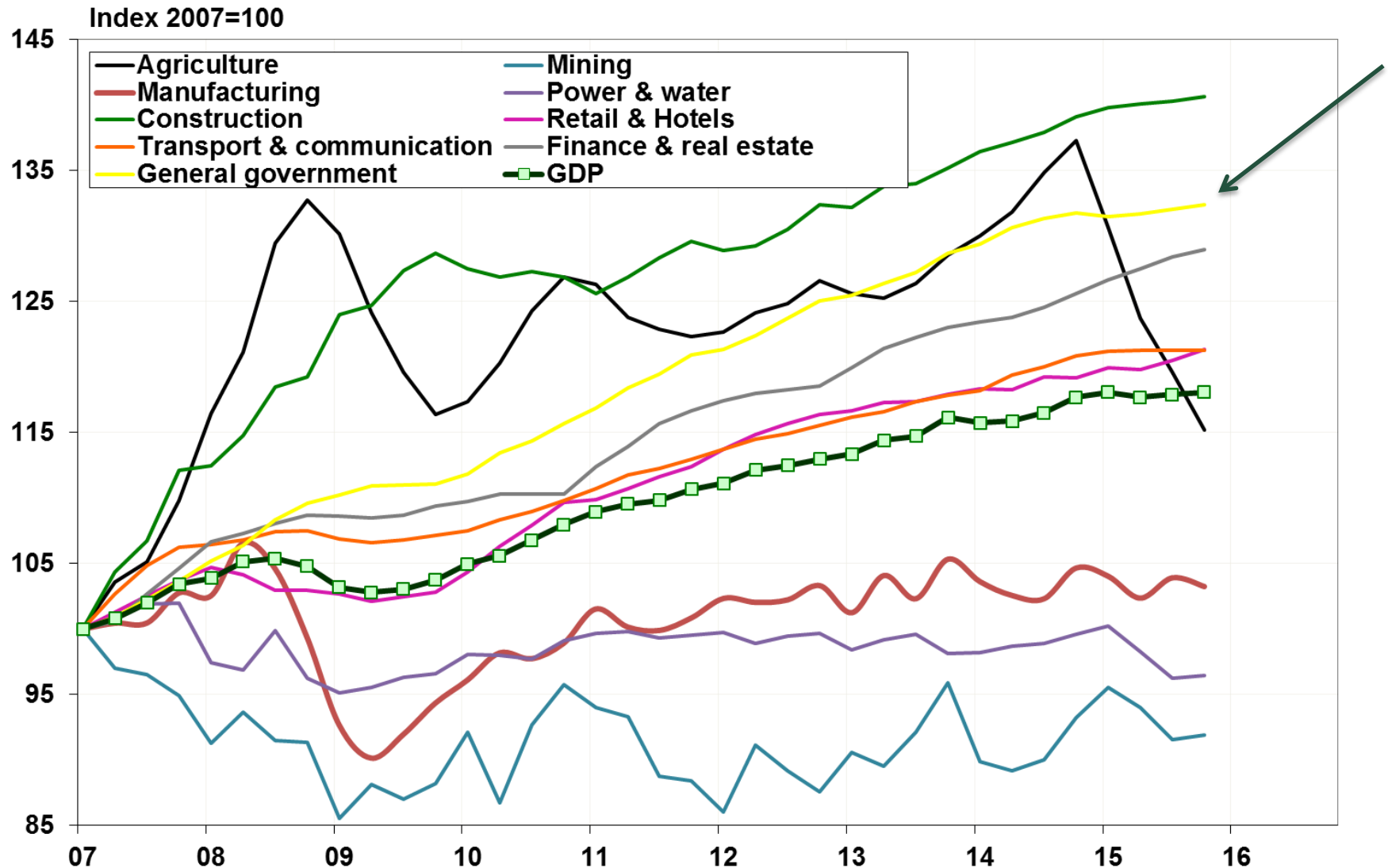
■ Increased policy uncertainty & political turmoil

Mining & manufacturing are not expected to stage a strong recovery in 2016

- Sharp reductions in capital expenditure
- Moderate increase in retrenchments

Increased government spending has supported services & consumer spending, propping up the economy in this business cycle

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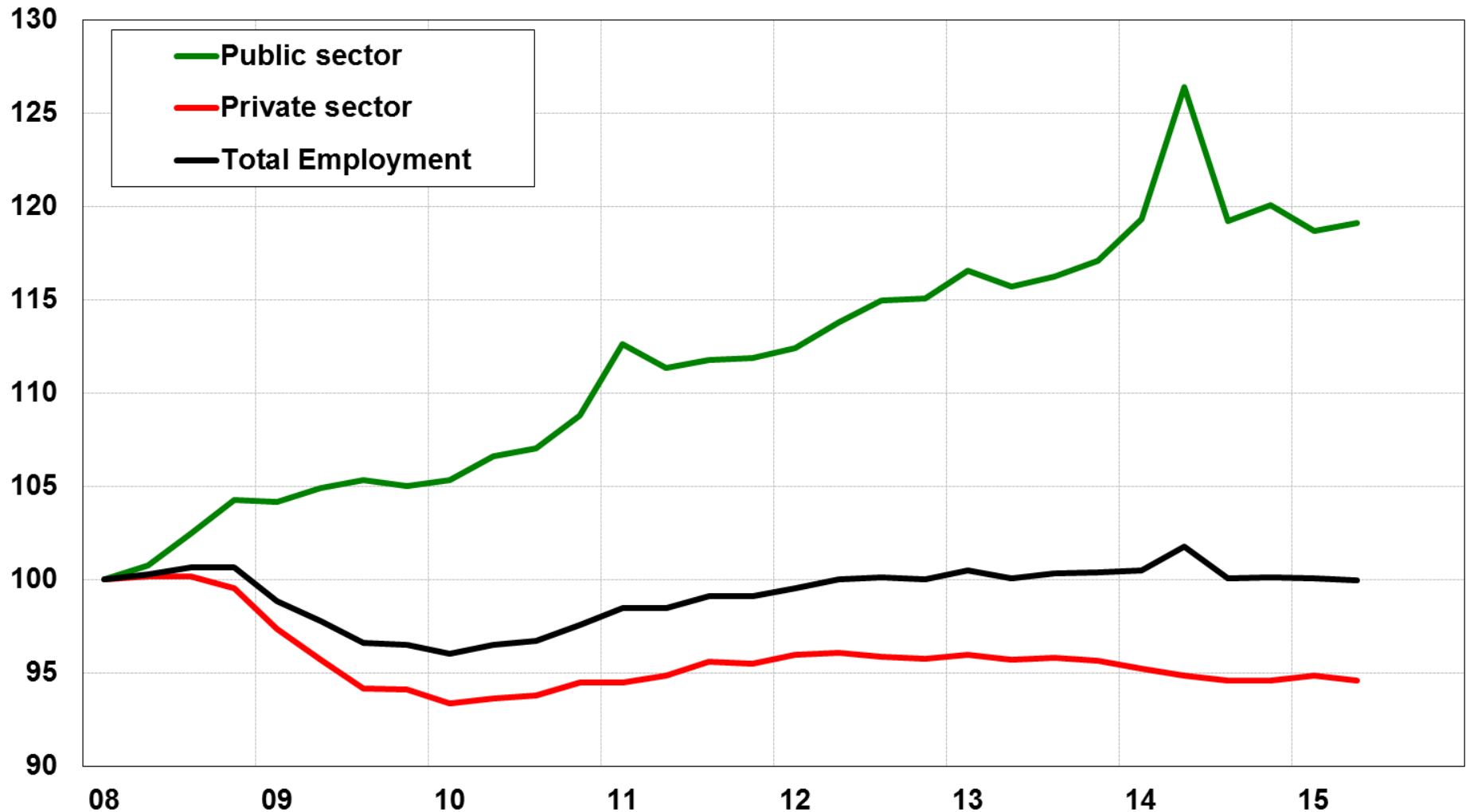
Source: Stats SA

Government will have to scale back the size of the civil service

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Employment trends: Index 2008=100



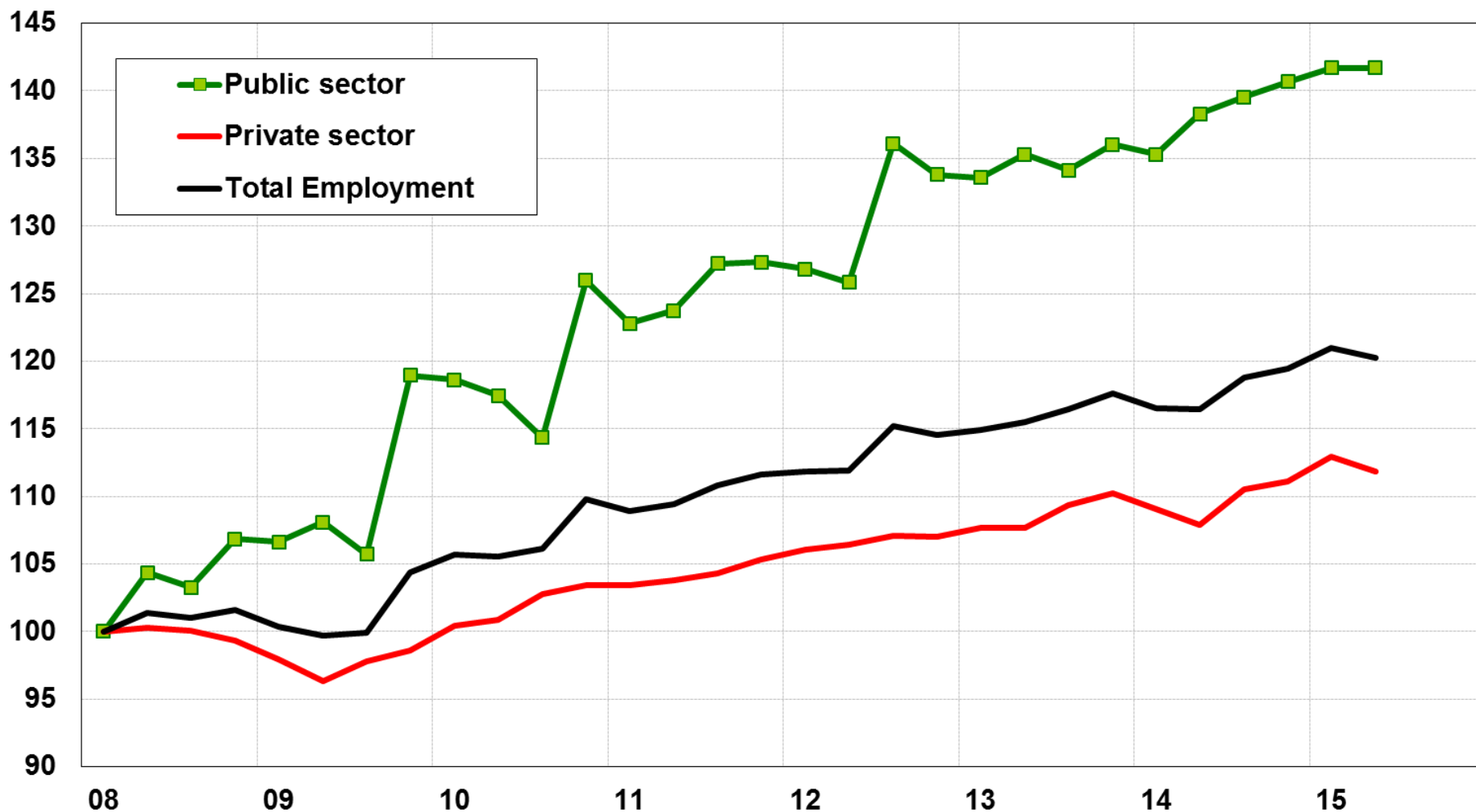
Source: South African Reserve Bank

...although wage growth will continue

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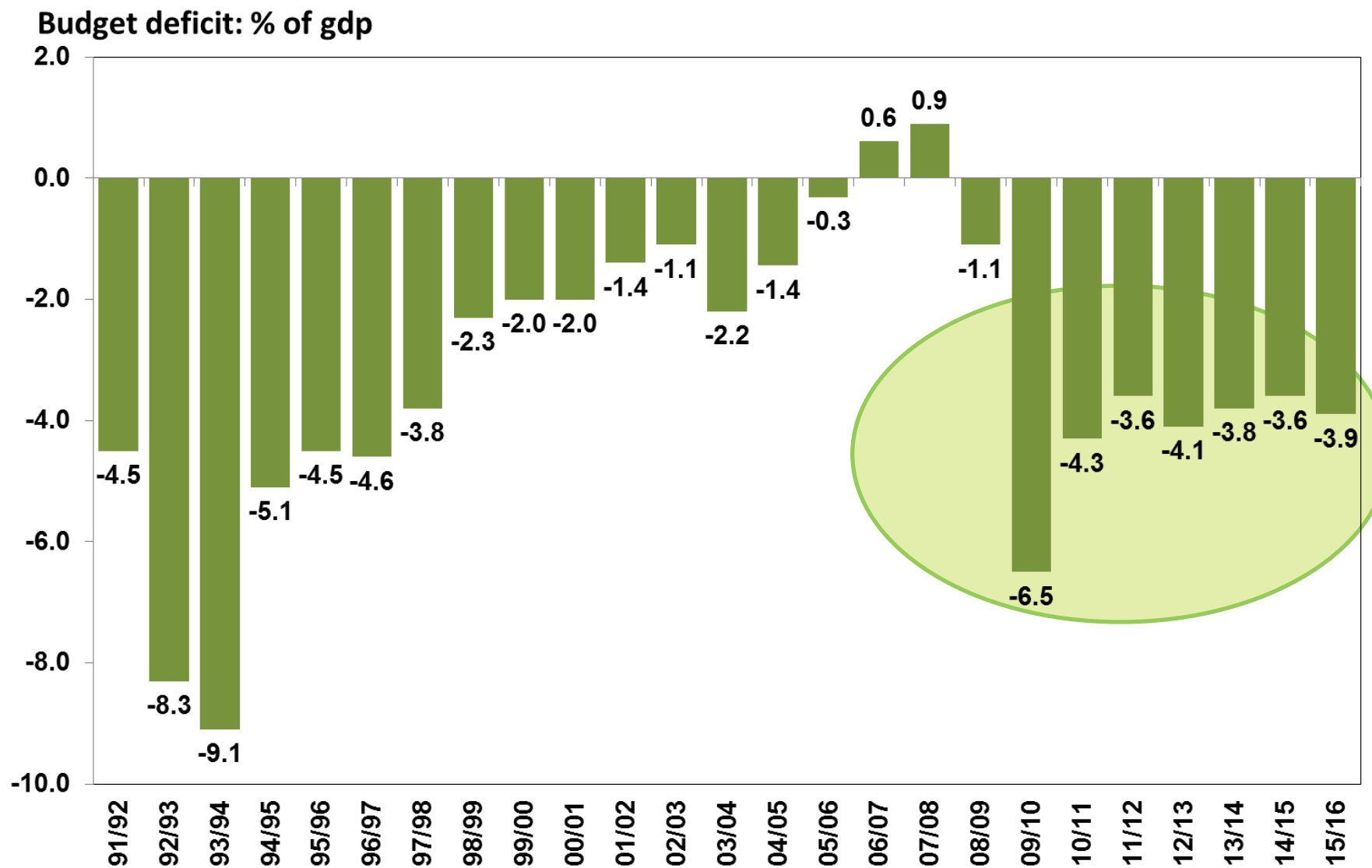
Real total wage bill: Index 2008=100



Source: South African Reserve Bank

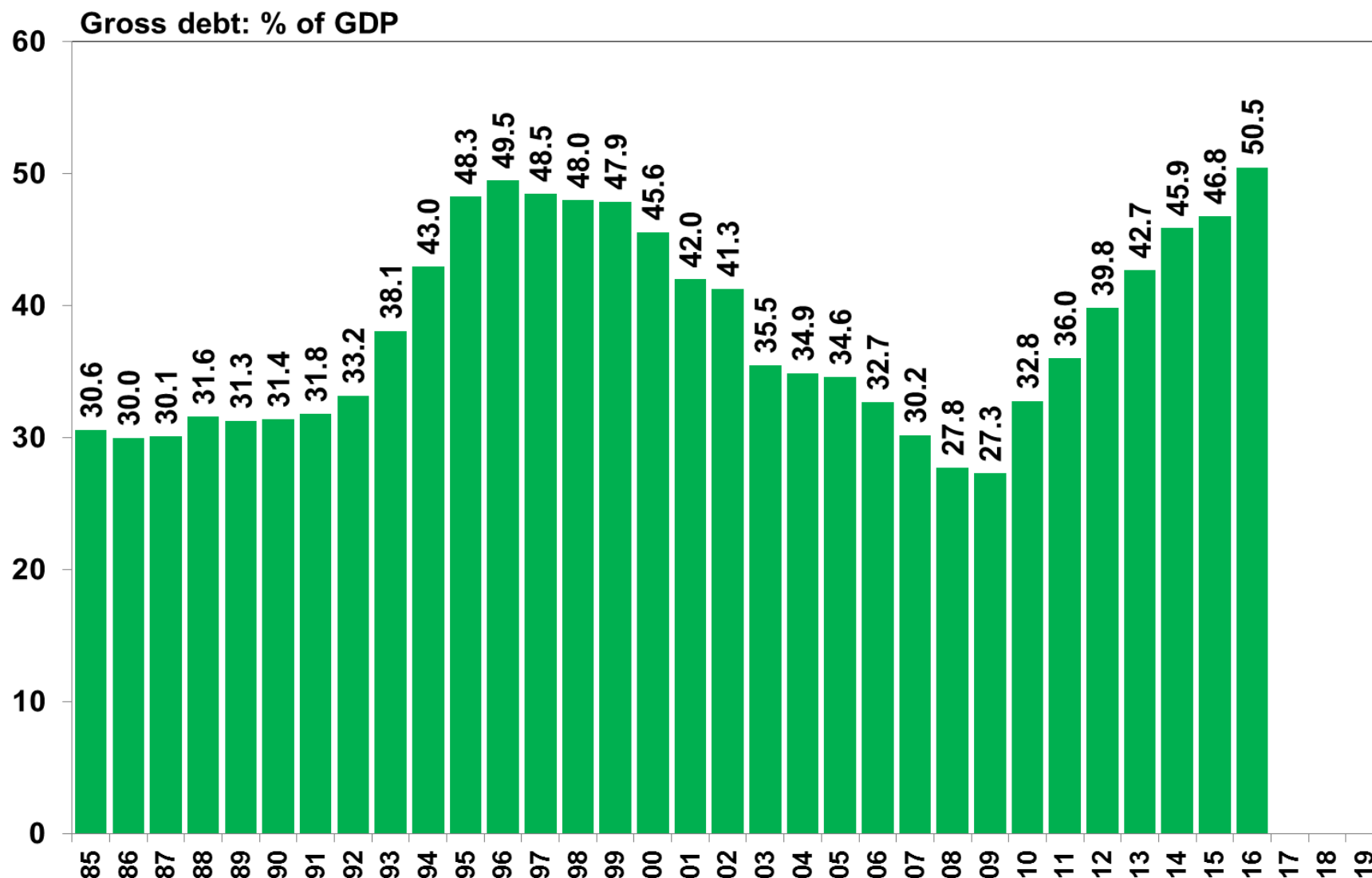
SA has simply been borrowing at a too alarming rate

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Source: 2015 MTBPS

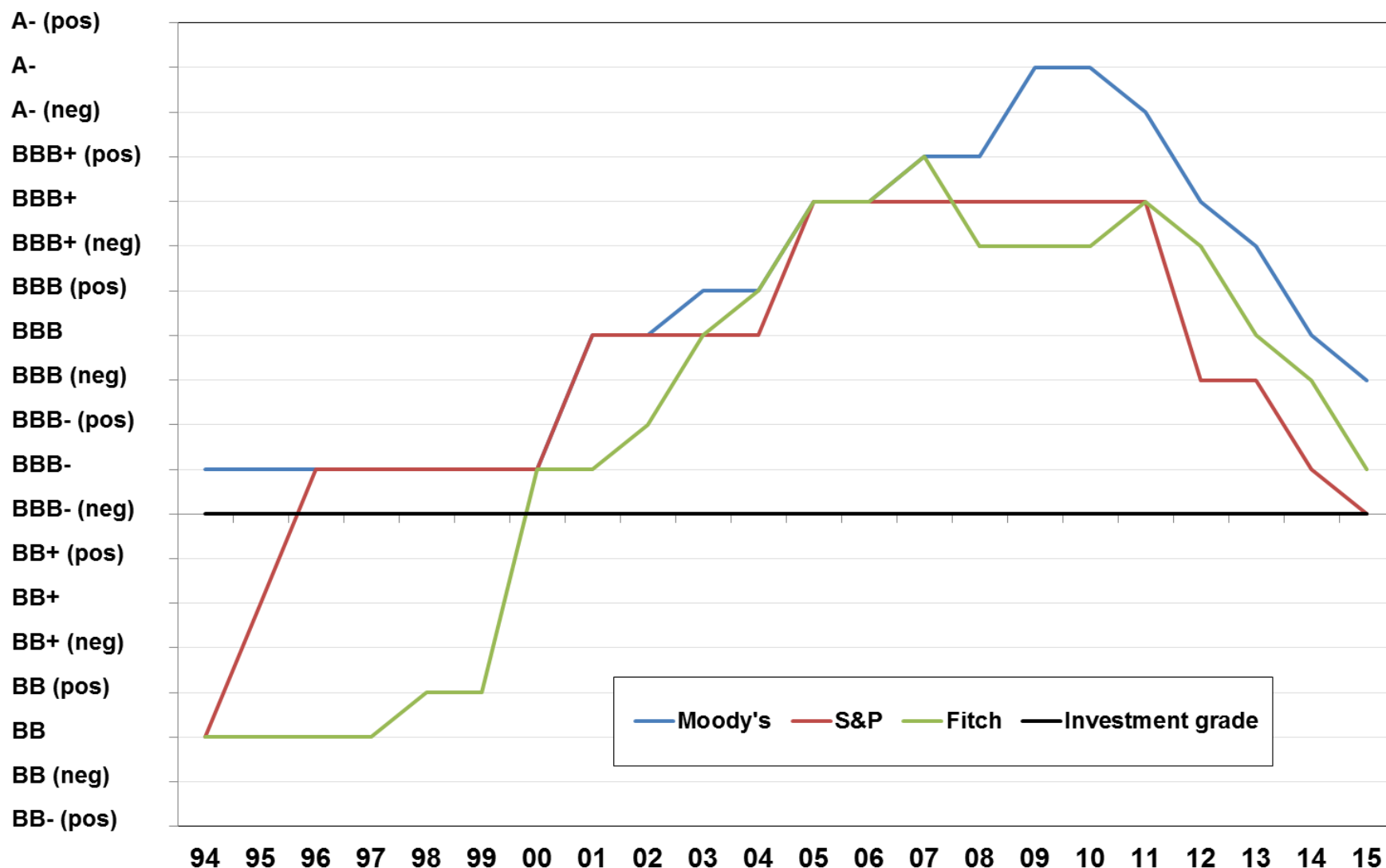
This has resulted in steep rise in government debt – there is no ammunition left



Source: 2015 MTBPS

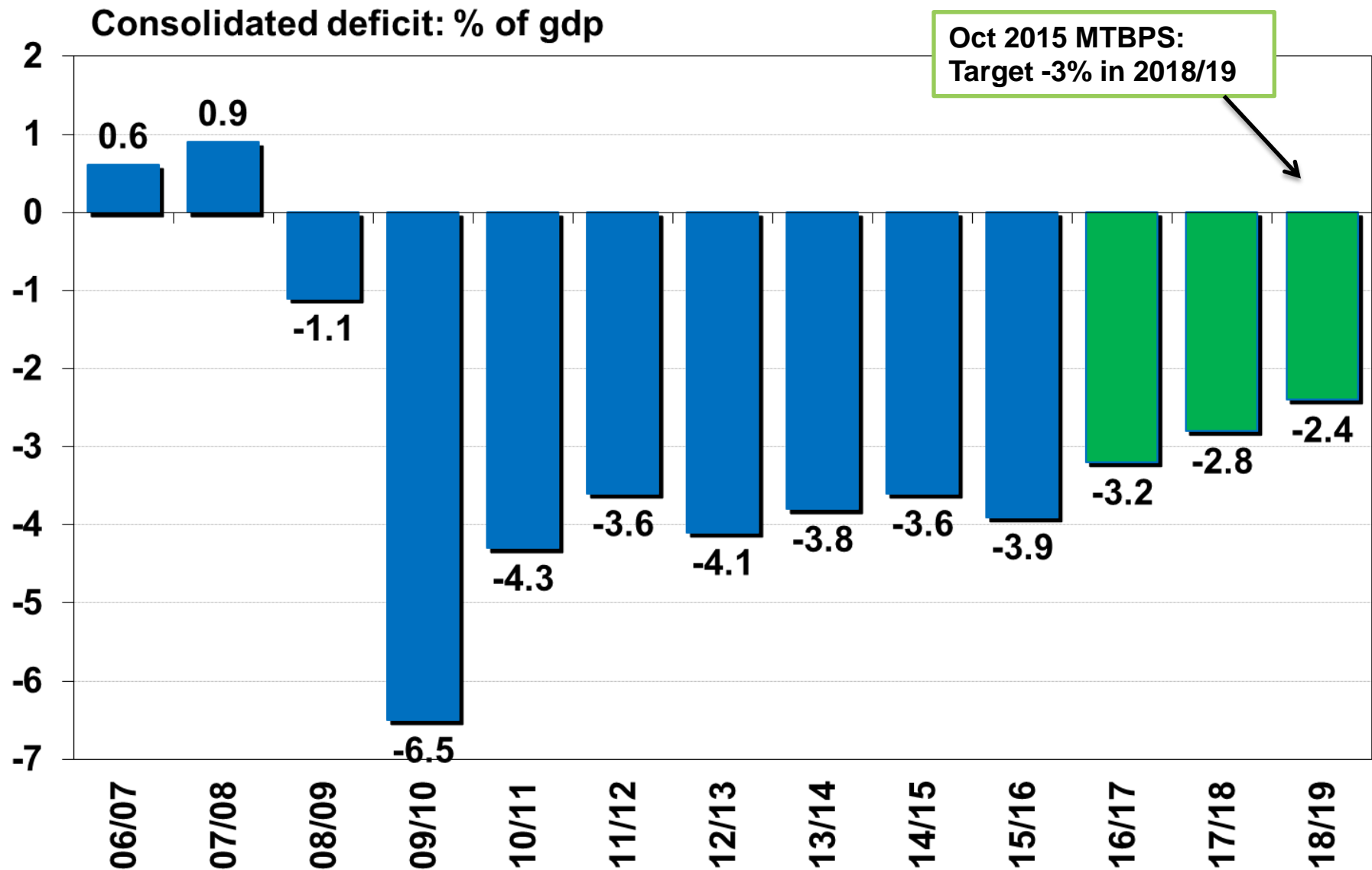
Fading economic growth, relatively large current and fiscal deficits have resulted in a series of sovereign rating downgrades

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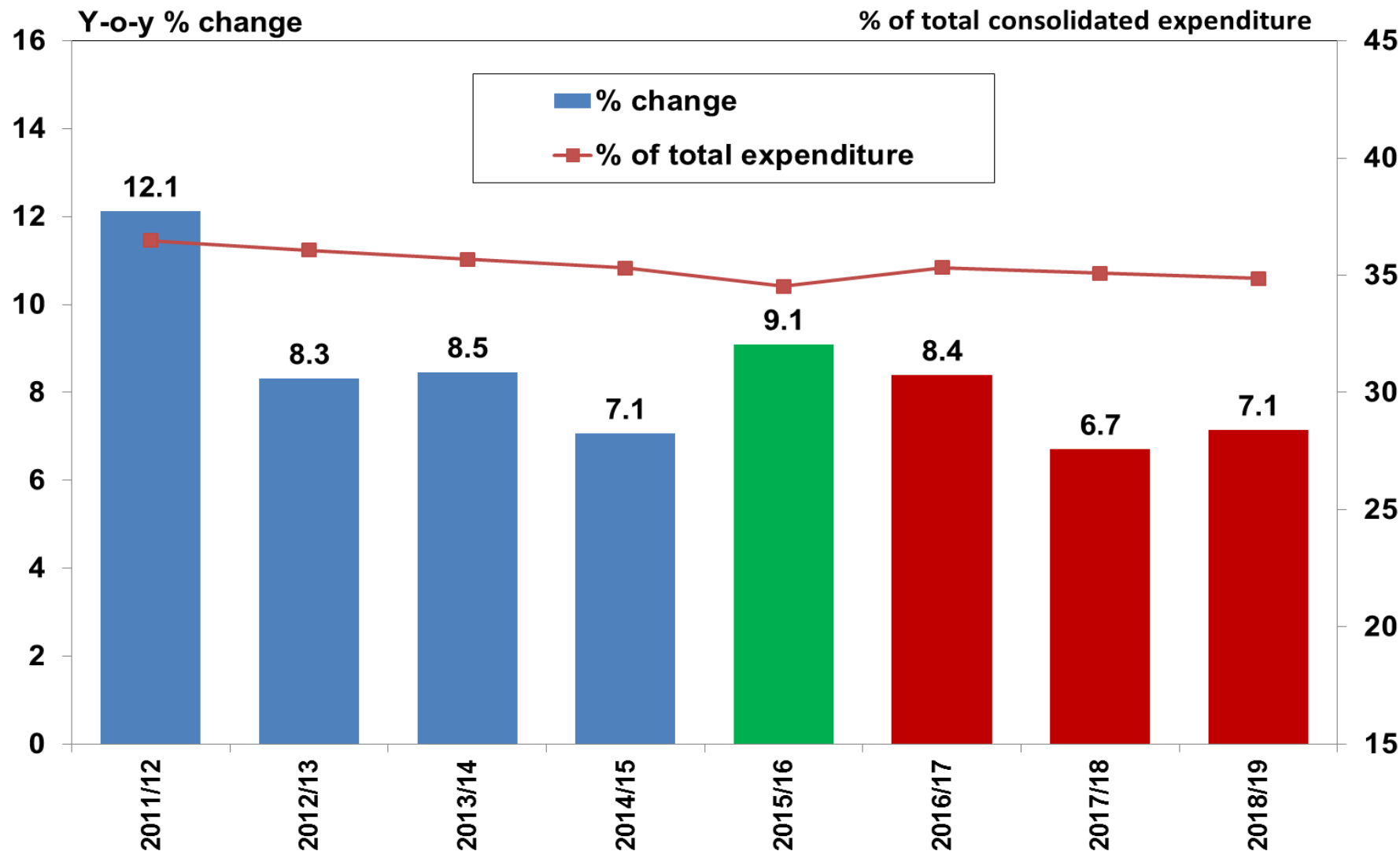
Source: Various credit rating agencies

Minister Gordhan produced a faster pace of deficit reduction



Source: 2015 MTBPS

The big boost provided to household disposable income by public sector employment and pay is likely to fade in the years ahead



Source: National Budget Review 2016

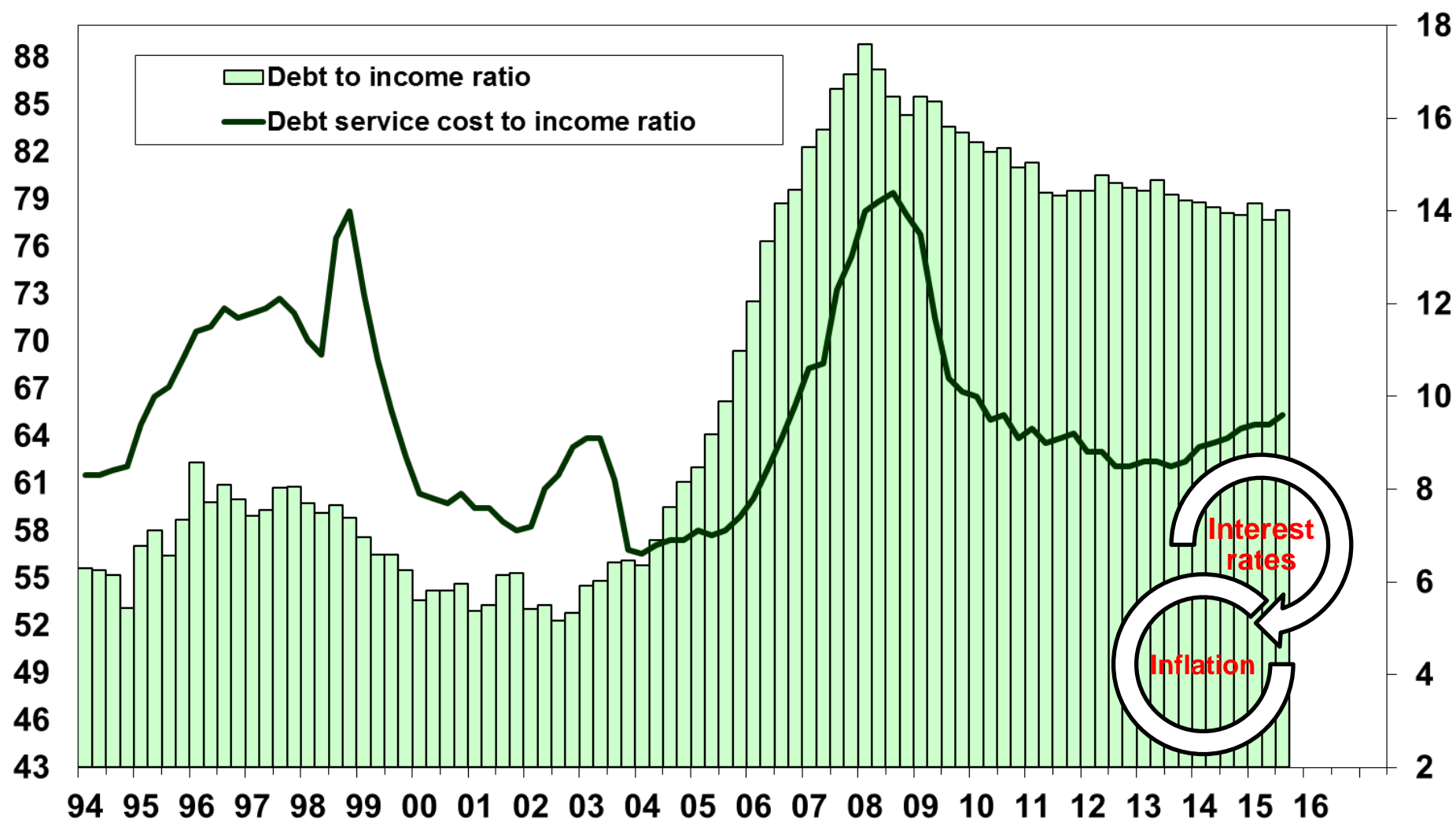
Rising interest rates are placing further strain on households with high debt burdens

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Debt as % of income

Debt service costs as % of income



Source: SARB QB December 2015

The inflation outlook has deteriorated significantly

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■ Rising food inflation

- Worst drought in 25 years are expected to result in 30% drop in field crop production
- Weaker rand will push up the cost of increased food imports

■ A vulnerable rand

- The rand fell by over 25% against the US dollar in 2015, but has recovered some lost ground in recent weeks
- Downside risks remain:
 - SA sovereign risk rating downgrade to speculative status
 - Domestic political developments
 - Changes in global risk appetites – Risk aversion likely to be triggered by a loss in economic momentum in China, renewed downward pressure on commodity prices and signs of that US interest rates are set to increase faster than currently expected

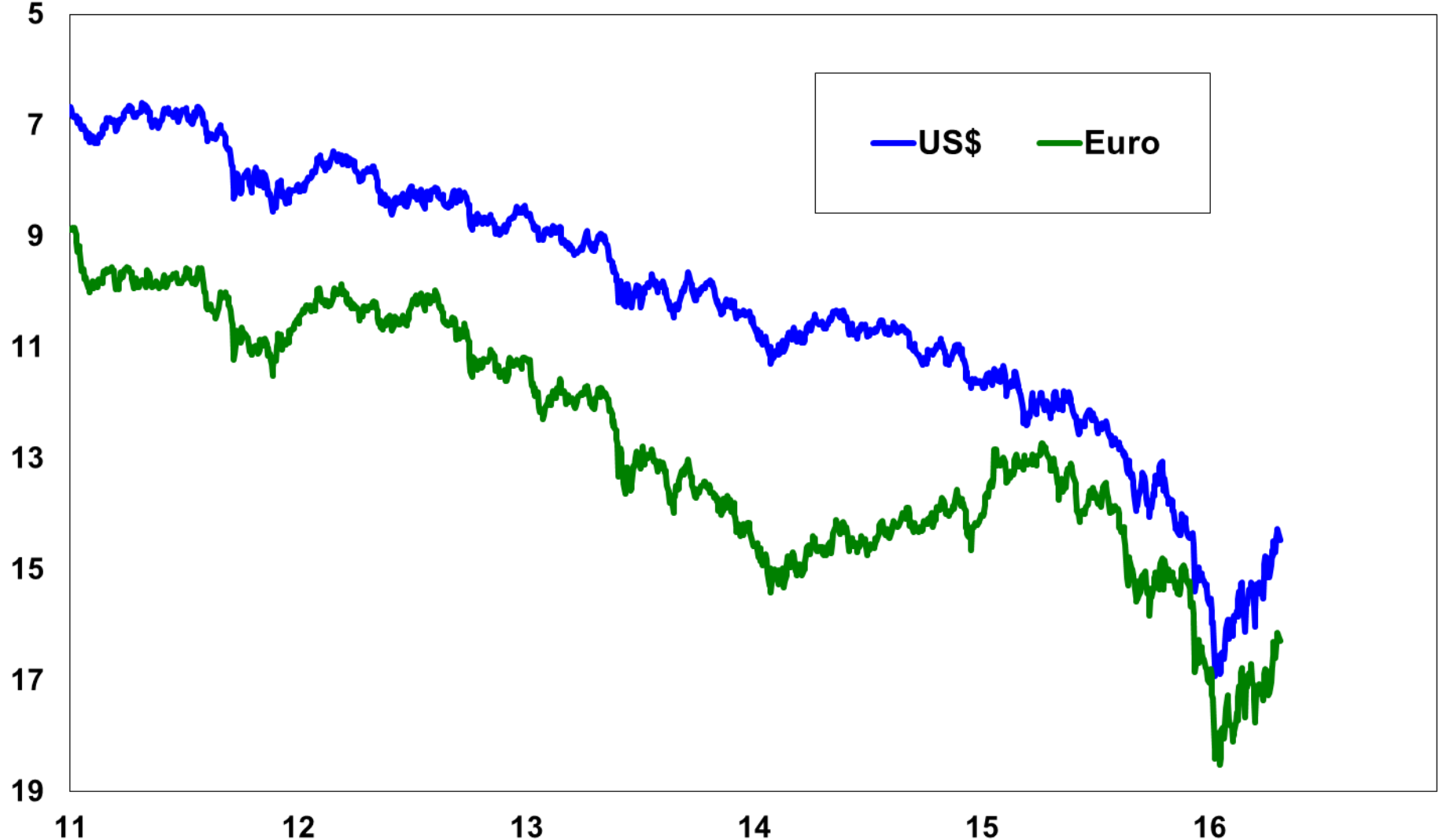
■ A turnaround in global oil prices

The rand have been very vulnerable and extremely volatile

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Rand/ US\$ and euro



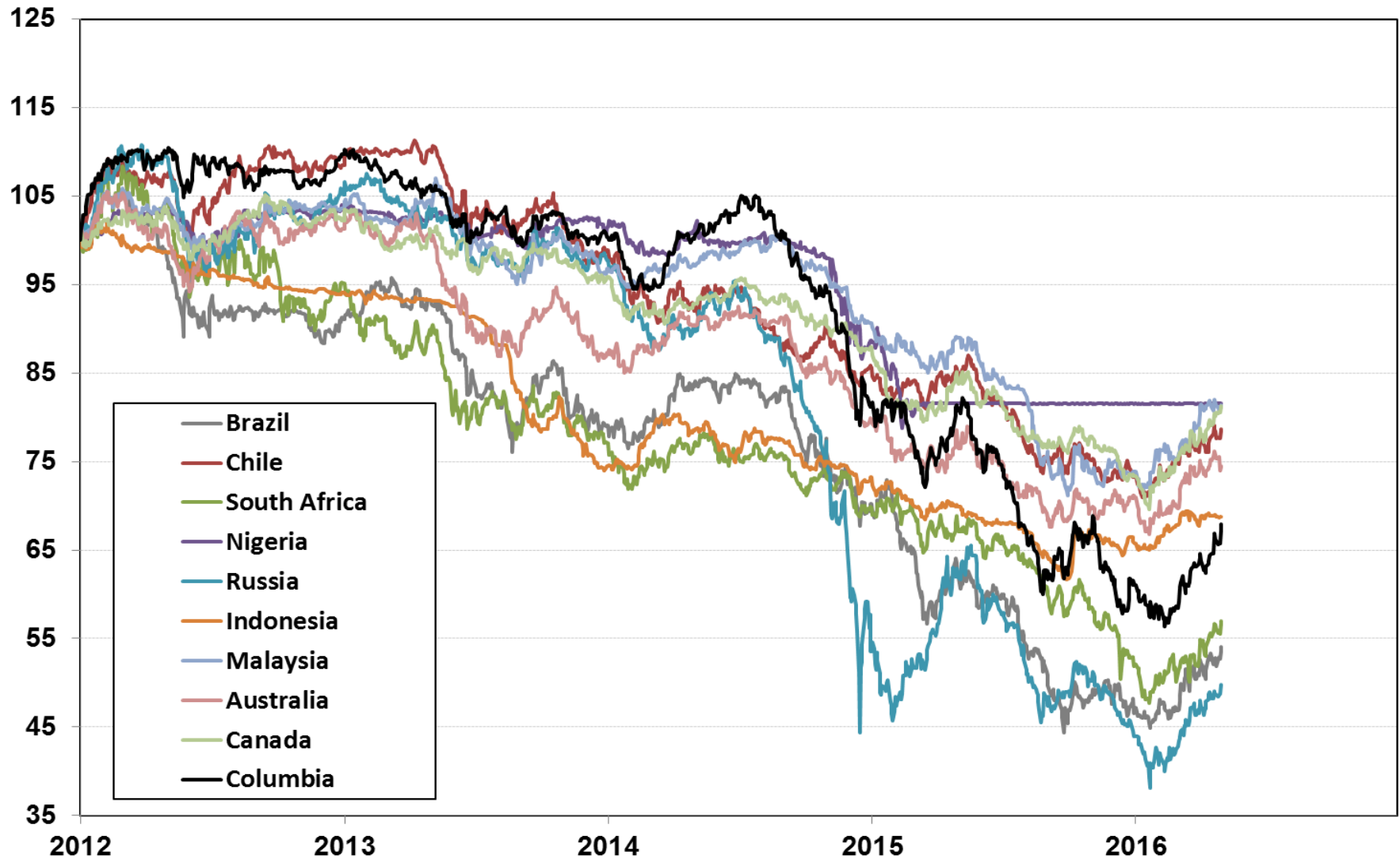
Source: Reuters

Most emerging market currencies have been punished on bad news on China & commodities, but supported by signs of weak growth in US

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Currencies against the US\$: Index 2012=100



Source: Stats SA & Nedbank calculations

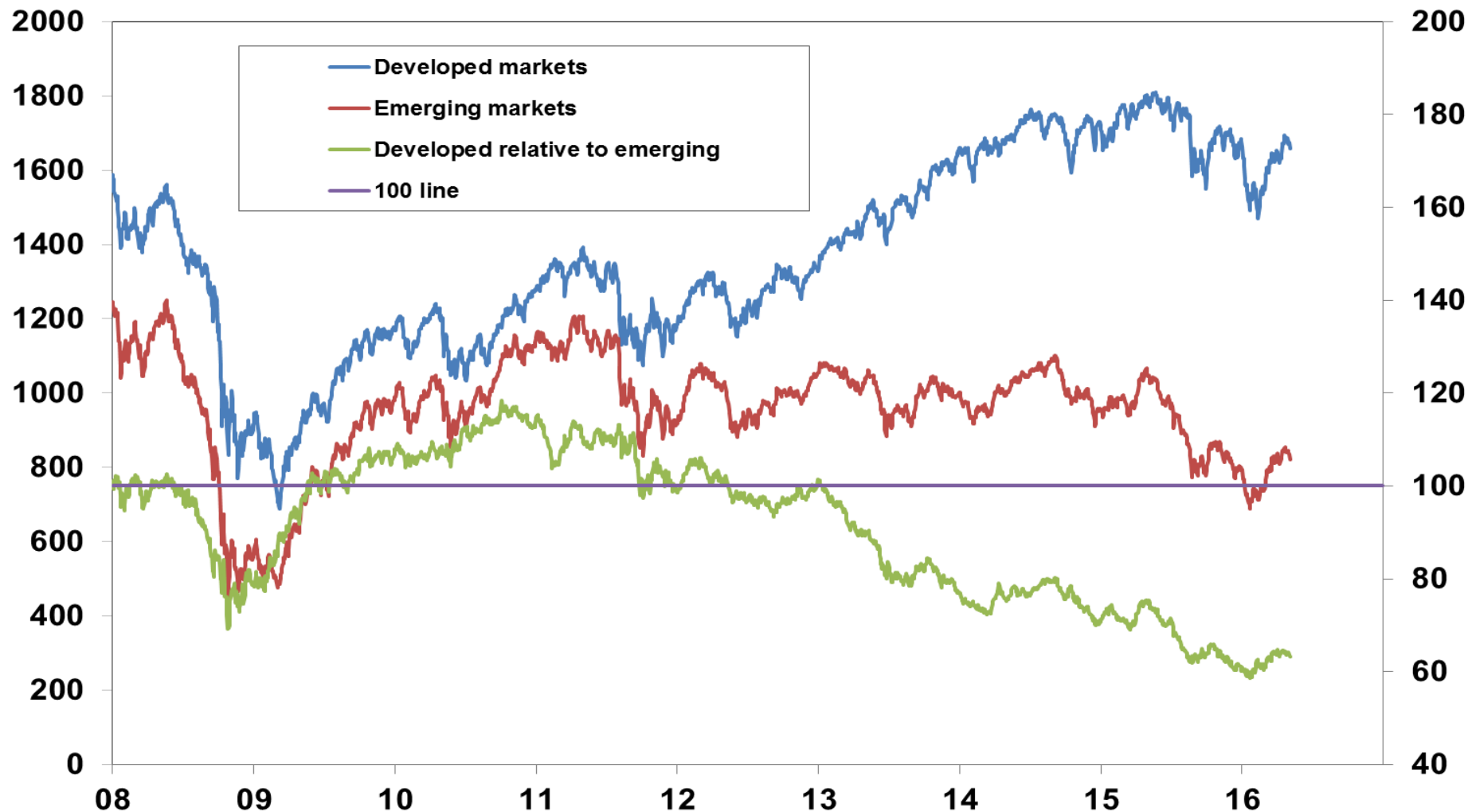
Capital flows have been primarily influenced by global risk perceptions

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MSCI equity indices

Relative performance



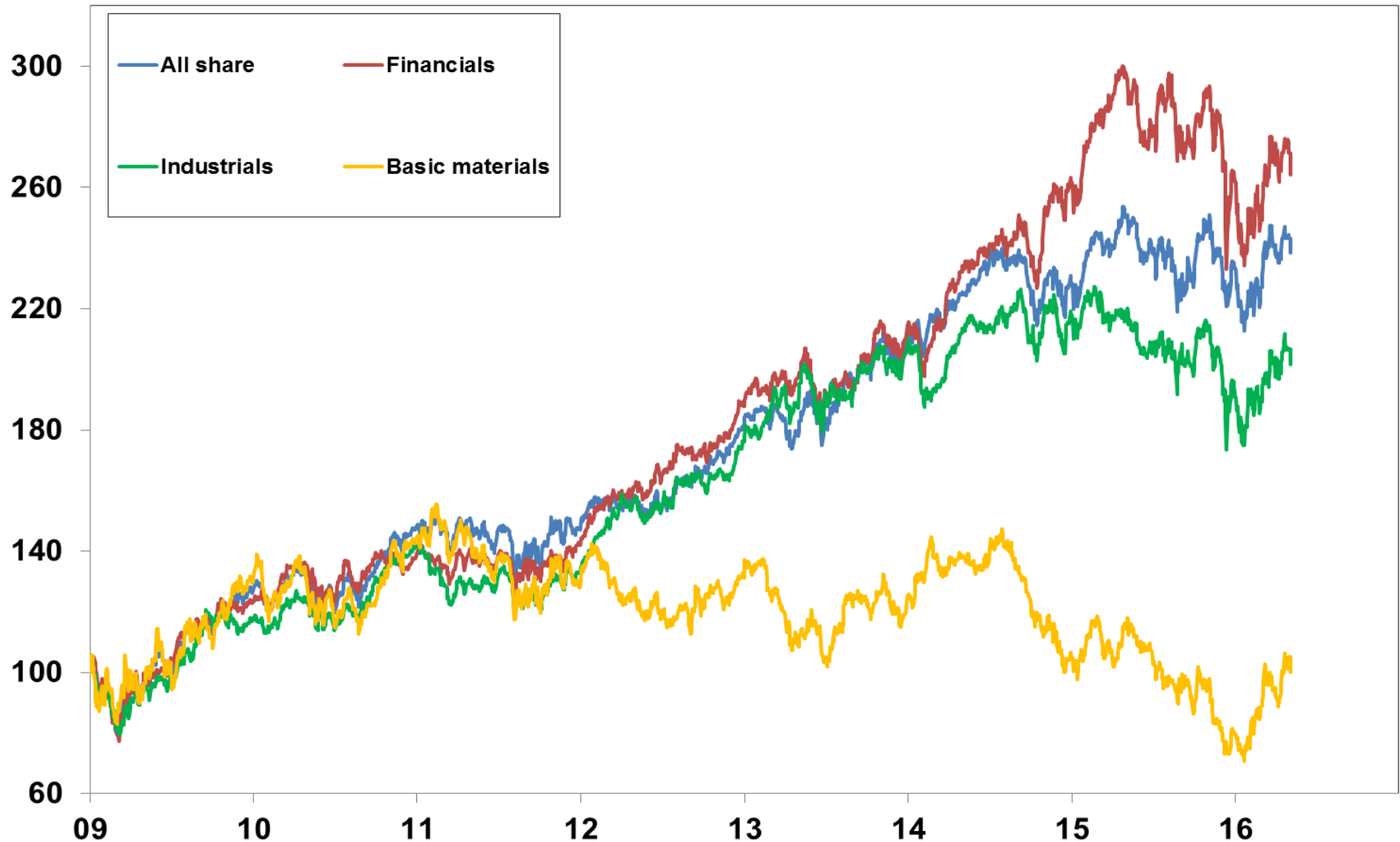
Source: Thompson Reuters Datastream

Hope floats again...the stock market is bouncing back

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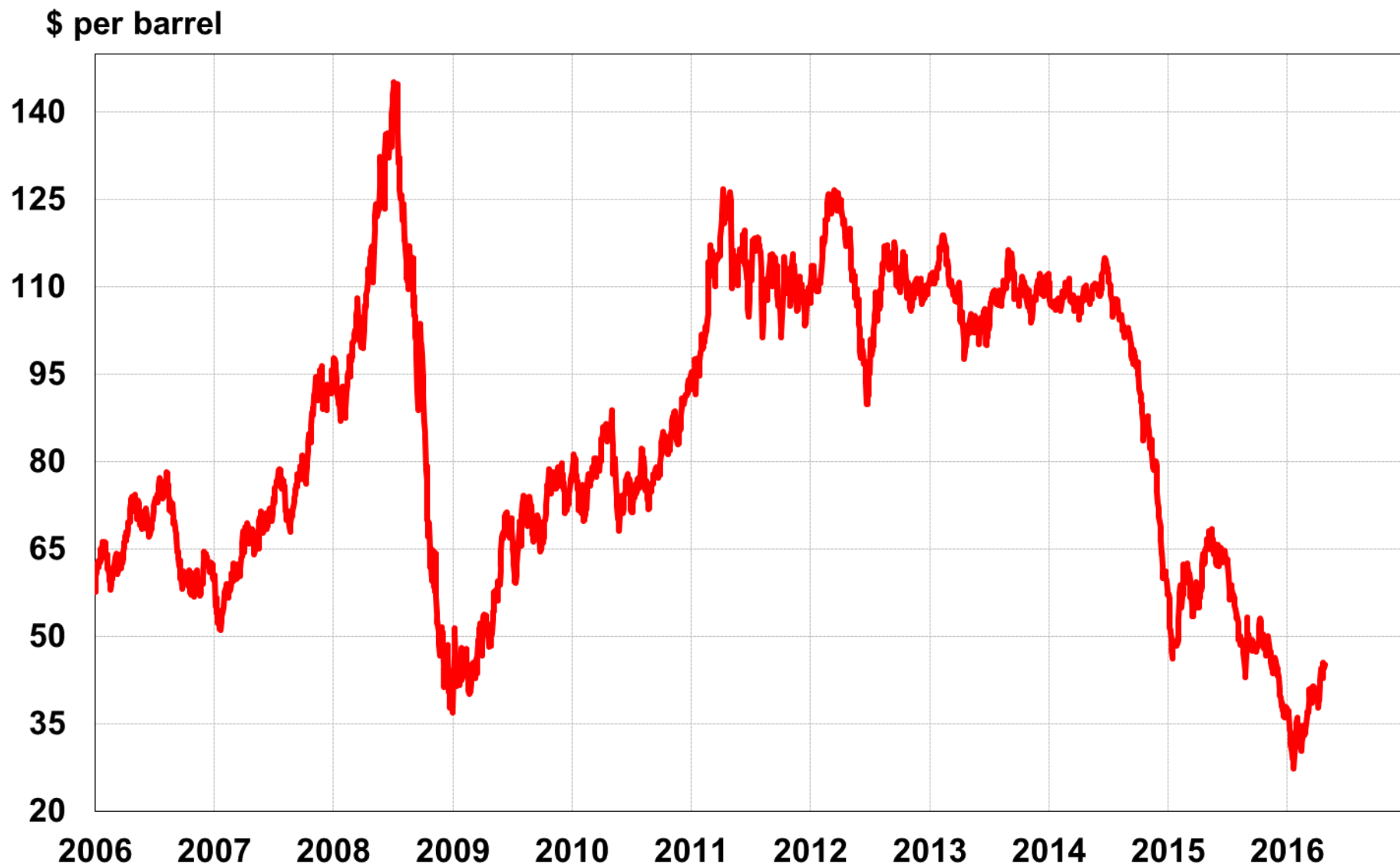
Index 2009=100



Source: INET & Nedbank calculations

The worst of the decline in oil prices is probably over, which also add upward pressure to inflation

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Source: Reuters

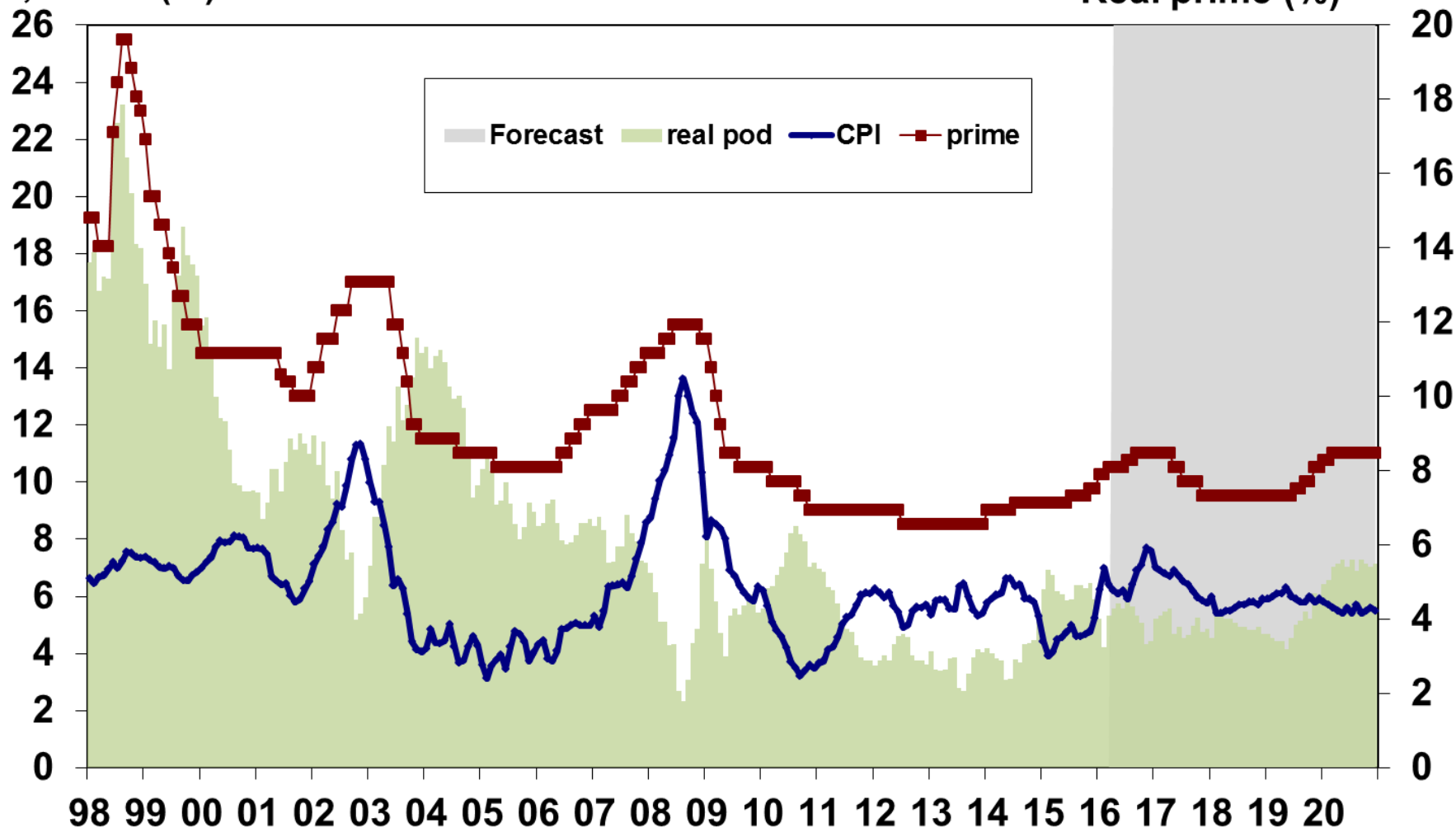
A deteriorating inflation outlook has already resulted in higher interest rates and the upward trend is expected to continue

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CPI, Prime (%)

Real prime (%)

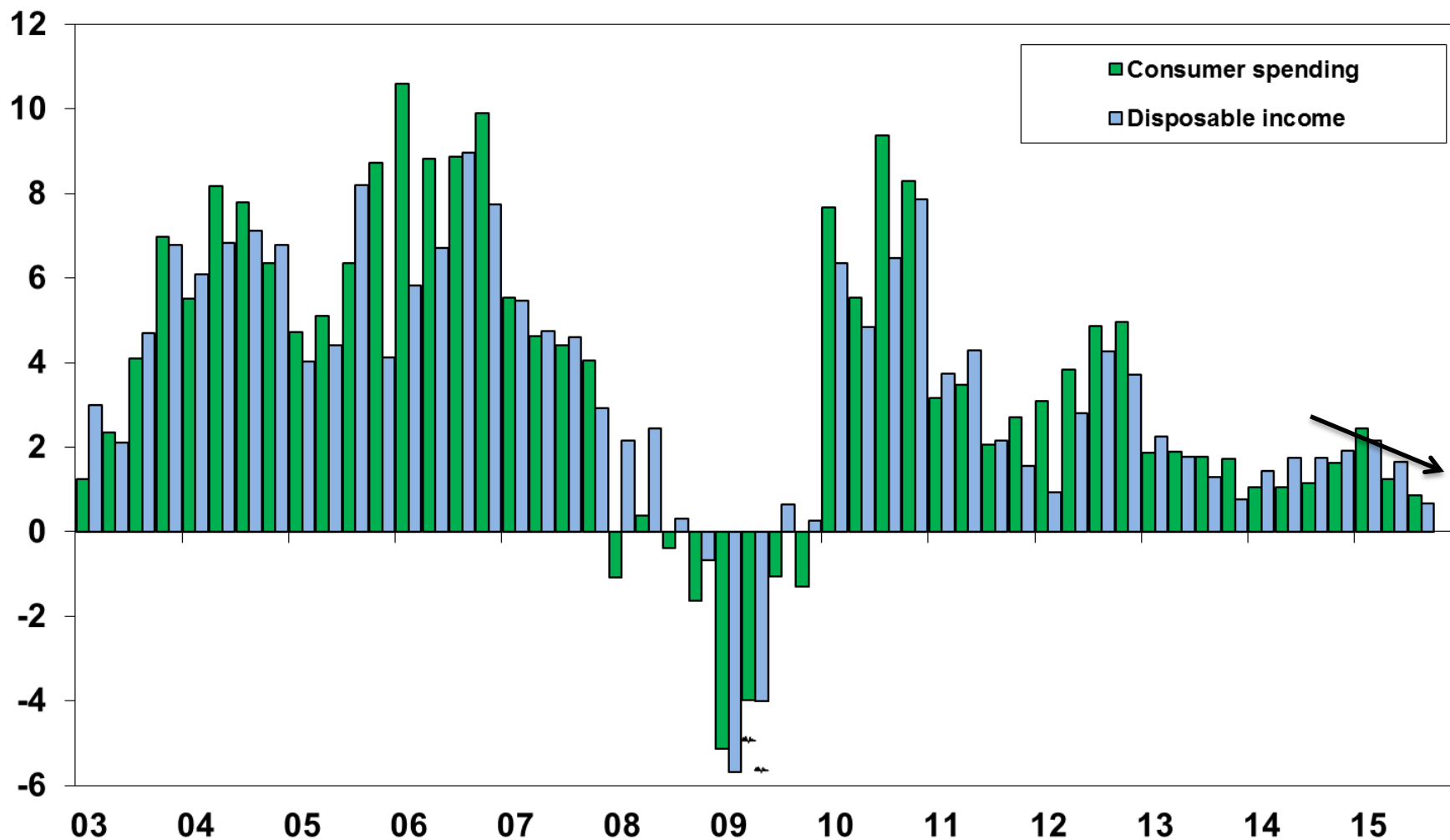


Slowdown in consumer spending is likely to intensify (only 0.7% growth in 2016)

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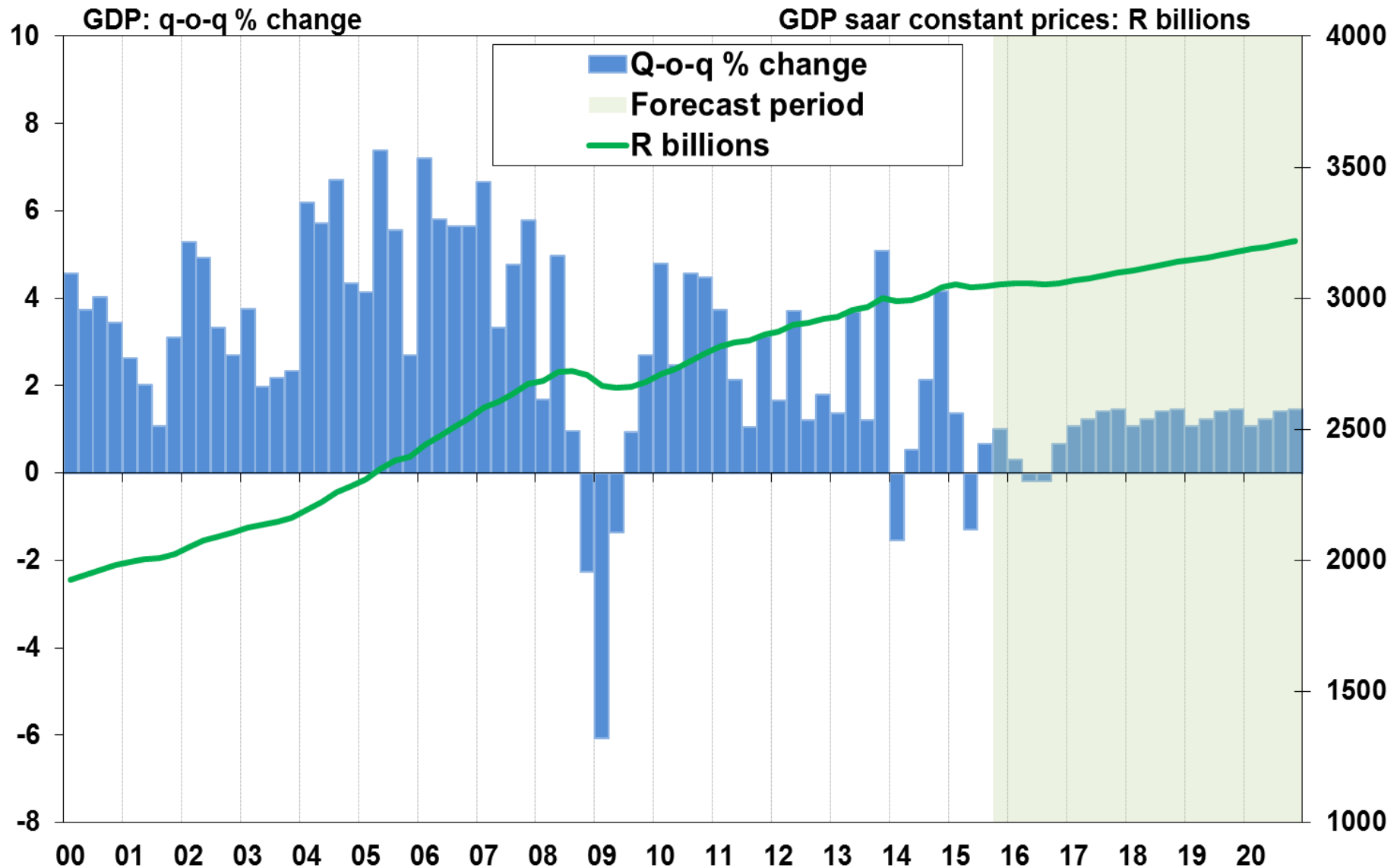


Spending & Income: Q-o-q % change (saar)



Economic growth forecast to weaken even further – slipping into short & shallow recession Q2 and Q3

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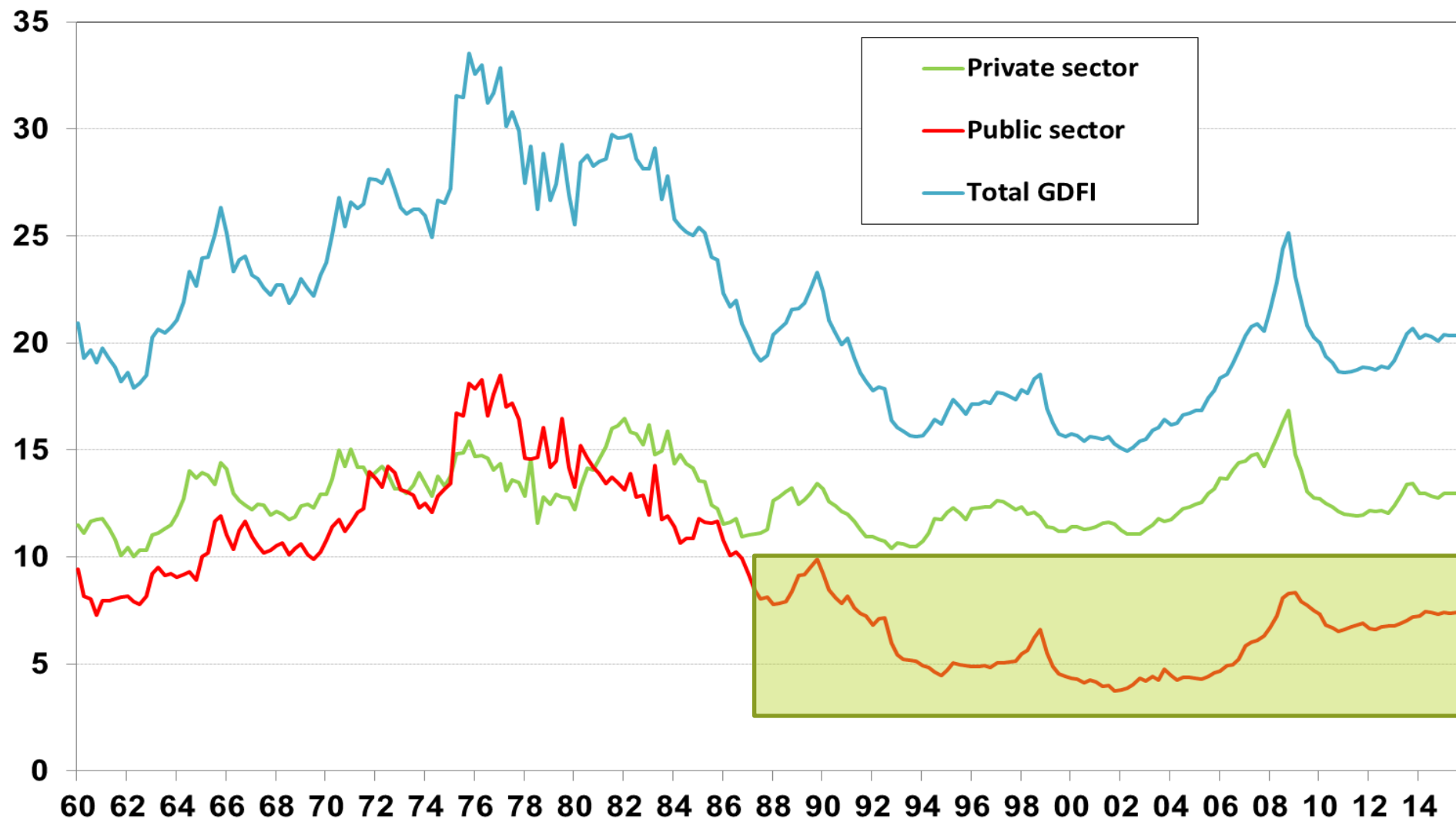
	2011	2012	2013	2014	2015	2016	2017	2018
Economic growth - Annual growth rates (%)								
Consumer spending	4.9	3.4	2.9	1.4	1.6	0.7	1.0	1.4
Fixed investment	5.7	3.6	7.6	-0.4	1.4	-2.5	0.5	2.1
Exports	4.3	0.1	4.6	2.6	9.0	2.7	3.1	4.3
Imports	10.5	6.0	1.8	-0.5	5.7	2.1	4.3	5.6
GDP	3.2	2.2	2.2	1.5	1.3	0.2	0.9	1.5
Balance of Payments								
Current Account (R'bn)	-65.3	-161.7	-203.8	-206.6	-174.3	-151.1	-136.9	-152.7
As % of gdp	-2.2	-5.0	-5.8	-5.4	-4.4	-3.5	-2.9	-2.9
Interest rates - Year-end rates								
3-month JIBAR	5.6	5.1	5.2	6.1	6.6	7.6	5.9	5.9
Prime	9.0	8.5	8.5	9.3	9.8	11.0	9.5	9.5
Long bond	8.1	6.8	8.0	7.9	9.7	9.9	8.5	8.5
Exchange rates - Annual averages								
Rand/US\$	7.27	8.22	9.66	10.85	12.93	15.50	16.53	17.23
Rand/Euro	10.12	10.57	12.83	14.33	14.28	17.21	17.81	18.16
Rand/GBP	11.66	13.09	15.14	17.83	19.73	22.10	23.34	23.79
CHF/Rand	0.122	0.114	0.096	0.085	0.075	0.061	0.059	0.058
Yen/Rand	10.96	9.74	10.04	9.82	9.35	7.31	6.86	6.60
Inflation - Annual averages								
New CPI	5.0	5.7	5.8	6.1	4.6	6.6	6.5	5.7

Although allocating large sums to capital expenditure to improve infrastructure, delivery has been frustratingly slow

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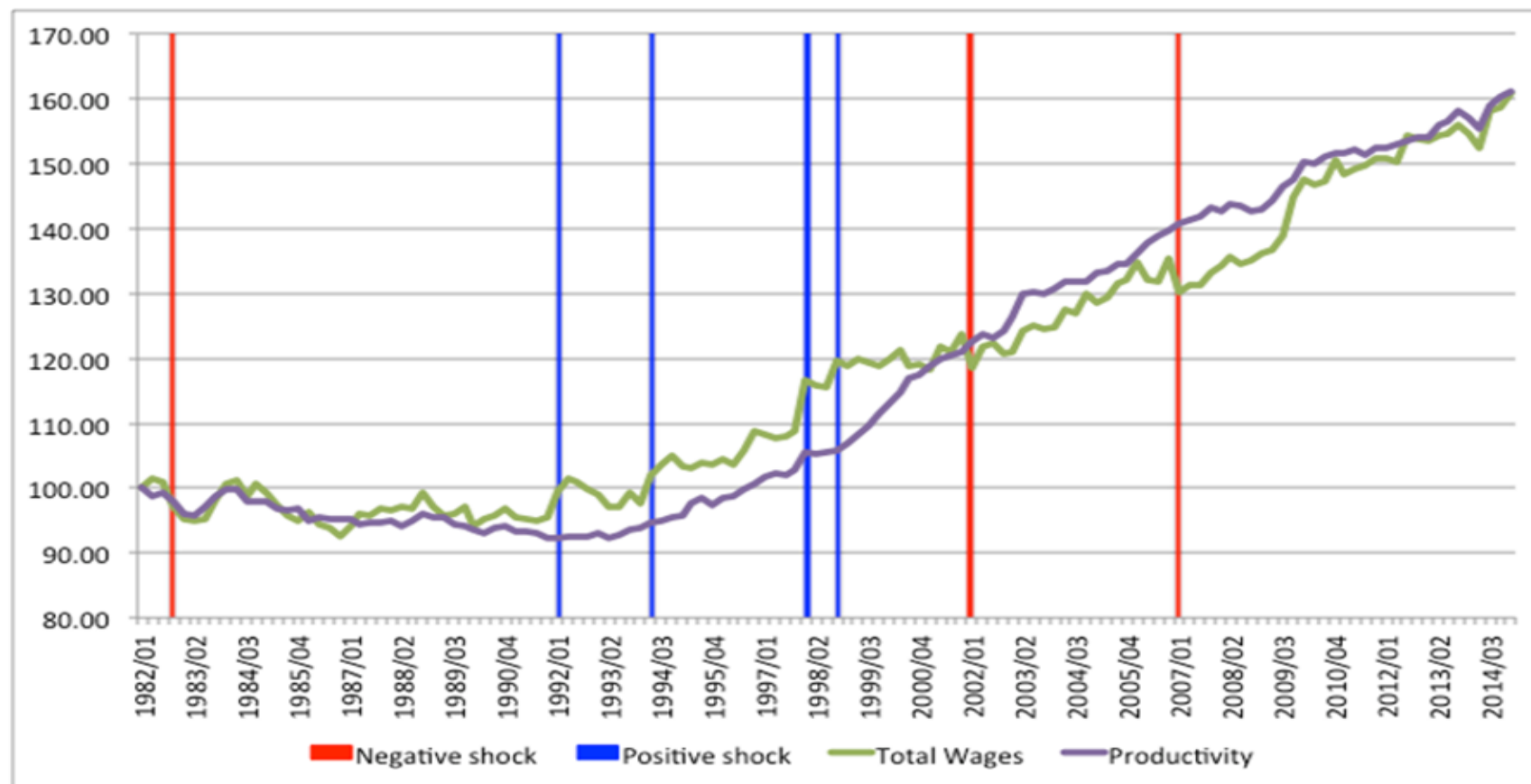
Capital formation as % of GDP at current prices



Source: SARB QB & Nedbank calculations

On average since 1982, a 1% increase in productivity has been associated with a 1% increase in real wages.

Figure 1. Real wages and productivity



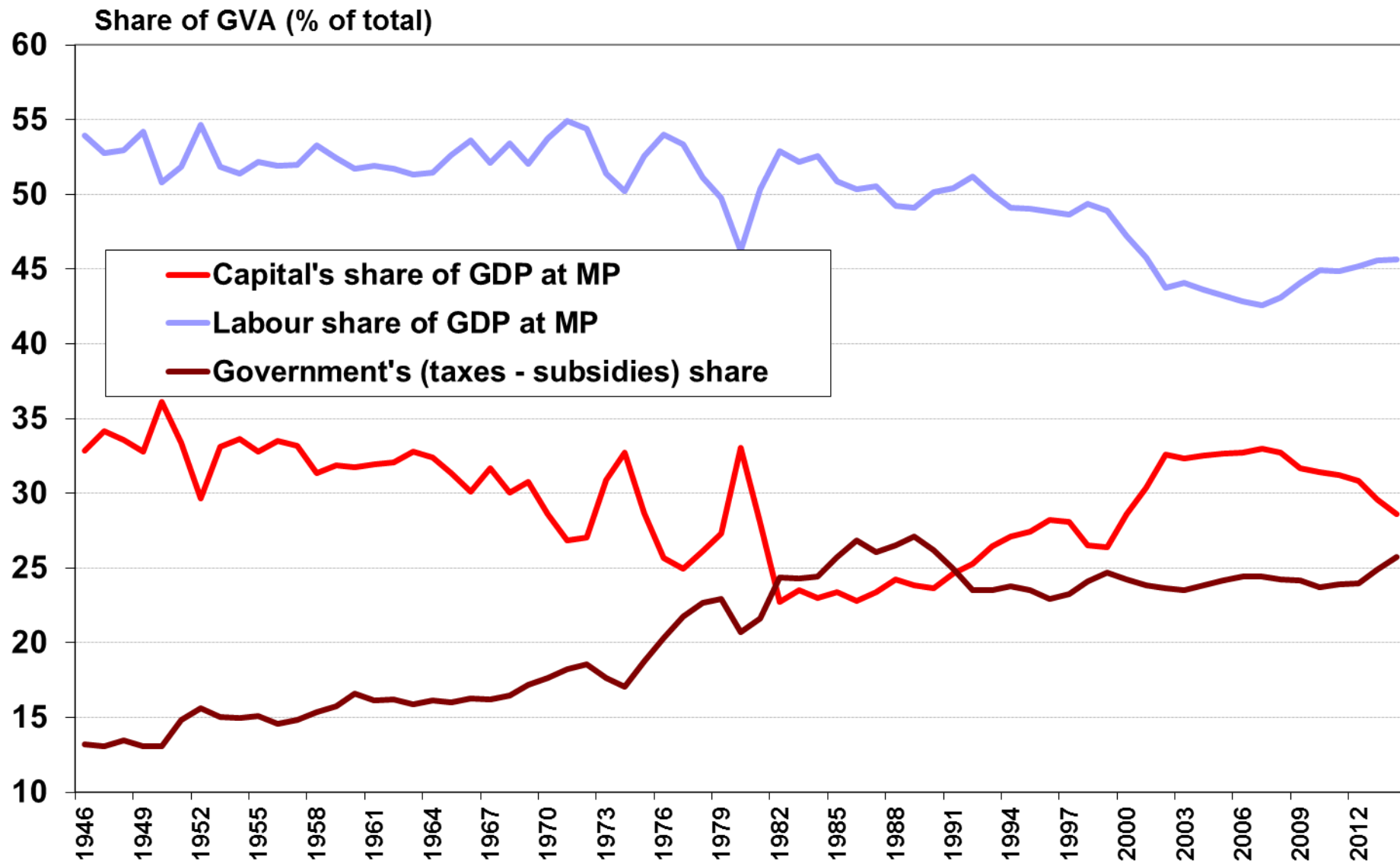
Source: SARB online download facility (2015) and author's calculations.

Note: The SARB data on the levels of wages and value-added contain breaks. To overcome this, the data on percentage changes in these variables were used to generate new 'level series'.

Source: Research by Philippe Burger of the University of the Free State

Both labour and government's share have increased since 2009

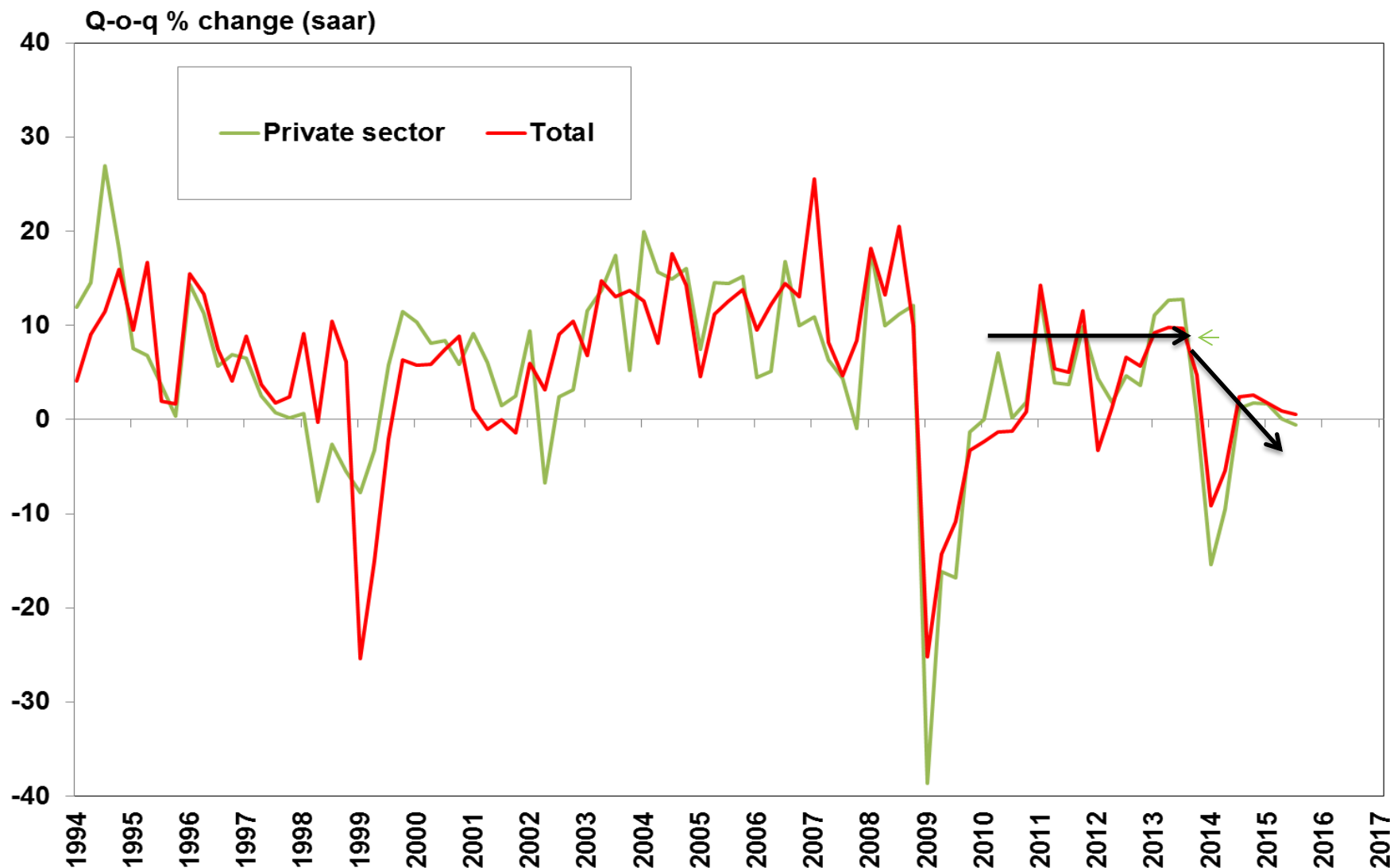
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Source: SARB QB December 2015

Capital expenditure by the private sector has been weak or contracting throughout this cycle

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Source: SARB QB December 2015

What are the implications of a downgrade to speculative or junk status for SA?

■ Capital outflows

- Most foreign funds have rules that prohibit investment in non-investment grade government bonds
- Rand-denominated government bonds totals R2 trillion rand, and global investors hold about 32.4% or around R650bn
- Foreign-currency government debt amounts to about R230bn
- The cost of borrowing to government will increase sharply
- Debt service costs will eat up more and more tax revenue, making it very difficult for government to delivery social services and cut the deficit at the same time

■ Capital outflows will trigger further rand weakness

- Place pressure on SARB's foreign exchange reserves
- Given a current account deficit of around 4% of GDP, vicious capital outflows may force the country to approach the IMF for assistance

■ Inflation will rise sharply

- The SARB will have little option but to increase interest rates. The peak in interest rates can be easily 200-300 basis points higher than it would have been with an investment grade rating
- All these factors together all likely to trigger recession

National Treasury first wants to fix SOEs & then step up infrastructure spending

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Public-sector infrastructure expenditure and estimates, 2012/13 – 2018/19

	2015/16		2016/17		2017/18		2018/19		MTEF	% ann avg	% of total
	%		%		%		%				
Energy	69.7	2.7	50.8	-27.1	49.9	-1.8	79.9	60.2	180.7	4.7	20.9
Water and sanitation	35.2	19.4	43.1	22.4	43.1	-0.0	45.9	6.5	132.1	9.2	15.3
Transport and logistics	99.5	9.4	96.2	-3.2	105.3	9.5	90.0	-14.5	291.6	-3.3	33.7
Other economic services	16.6	27.9	17.2	3.8	14.4	-16.0	14.5	0.4	46.2	-4.4	5.3
Health	9.2	17.0	8.8	-4.0	9.4	7.0	9.8	4.4	28.1	2.4	3.2
Education	17.4	12.9	17.7	2.1	17.8	0.3	18.4	3.5	53.9	2.0	6.2
Human settlements ¹	18.3	7.1	18.3	-0.1	21.1	15.2	22.3	5.8	61.6	6.8	7.1
Other social services	16.6	26.4	16.0	-3.9	16.2	1.6	17.0	5.0	49.2	0.8	5.7
Administration services	8.0	52.0	6.6	-17.1	7.6	14.8	7.8	3.4	22.0	-0.5	2.5
Total	290.4	11.7	274.8	-5.4	284.9	3.7	305.8	7.3	865.4	1.7	
National departments	17.3	28.1	19.6	13.4	16.4	-16.3	18.3	11.5	54.3	1.9	6.3
Provincial departments	62.7	11.1	63.6	1.5	69.8	9.8	72.9	4.3	206.3	5.1	23.8
Local government	56.6	6.3	58.2	2.8	57.5	-1.1	59.9	4.1	175.6	1.9	20.3
Public entities ³	28.7	49.5	26.2	-8.6	29.4	12.0	30.4	3.5	86.0	1.9	9.9
Public-private partnerships	1.7	-1.6	1.9	11.6	2.0	4.6	2.1	3.3	6.1	6.5	0.7
State-owned companies ³	123.4	6.5	105.2	-14.8	109.7	4.3	122.2	11.4	337.0	-0.3	38.9
Total	290.4	11.7	274.8	-5.4	284.9	3.7	305.8	7.3	865.4	1.7	

1. Human settlements includes public housing to households and bulk infrastructure amounting to R61.6 billion over the MTEF period

2. Administration services include infrastructure spending by the Department of International Relations, the Department of Home Affairs, the Department of Public Works, Statistics South Africa and their entities

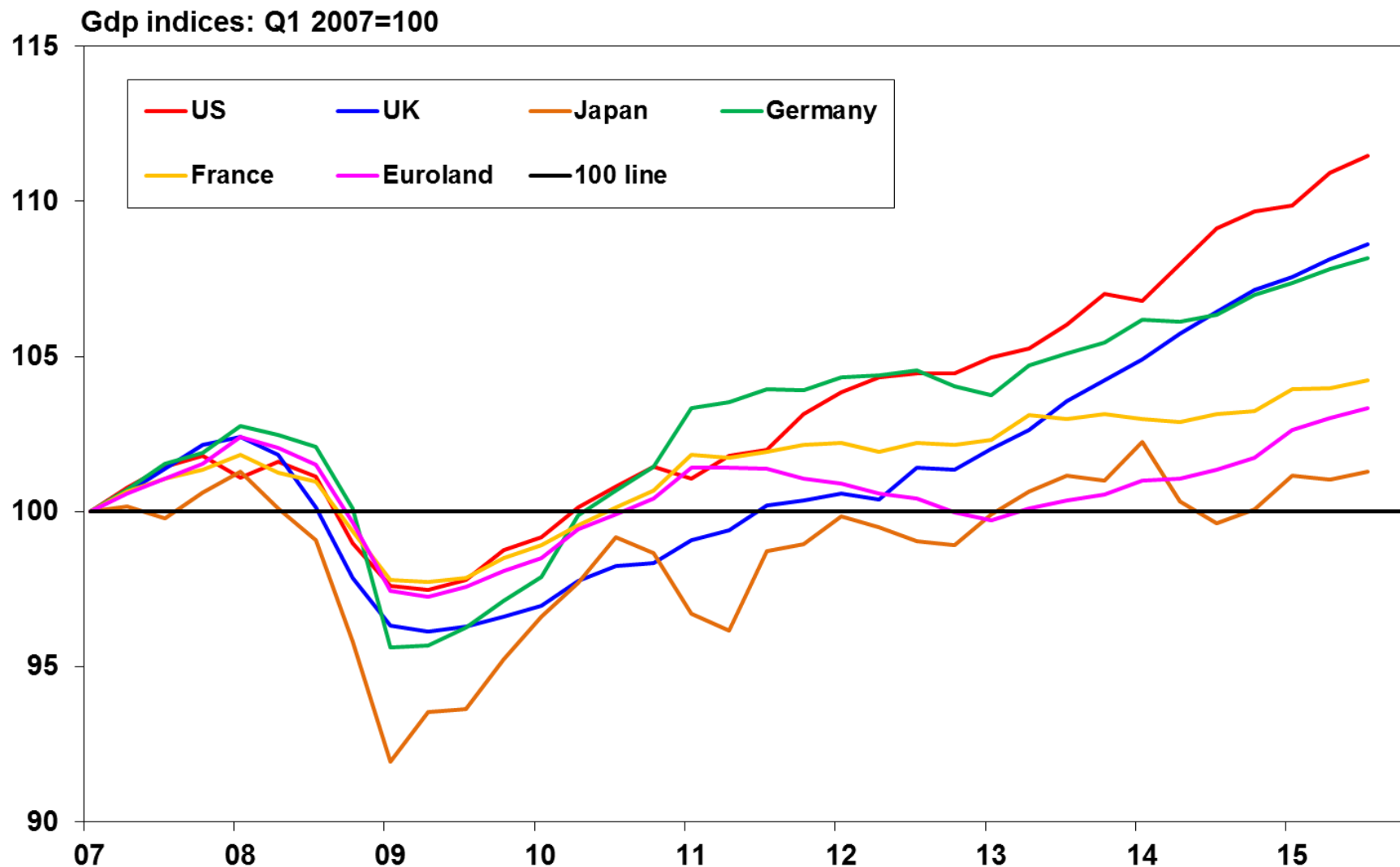
3. Public entities are financed by capital transfers from the fiscus and state-owned companies are financed from a combination of own revenue, borrowings and private funding

Source: National Treasury

Source: National Budget February 2016

The US recovery has outpaced most other major economies

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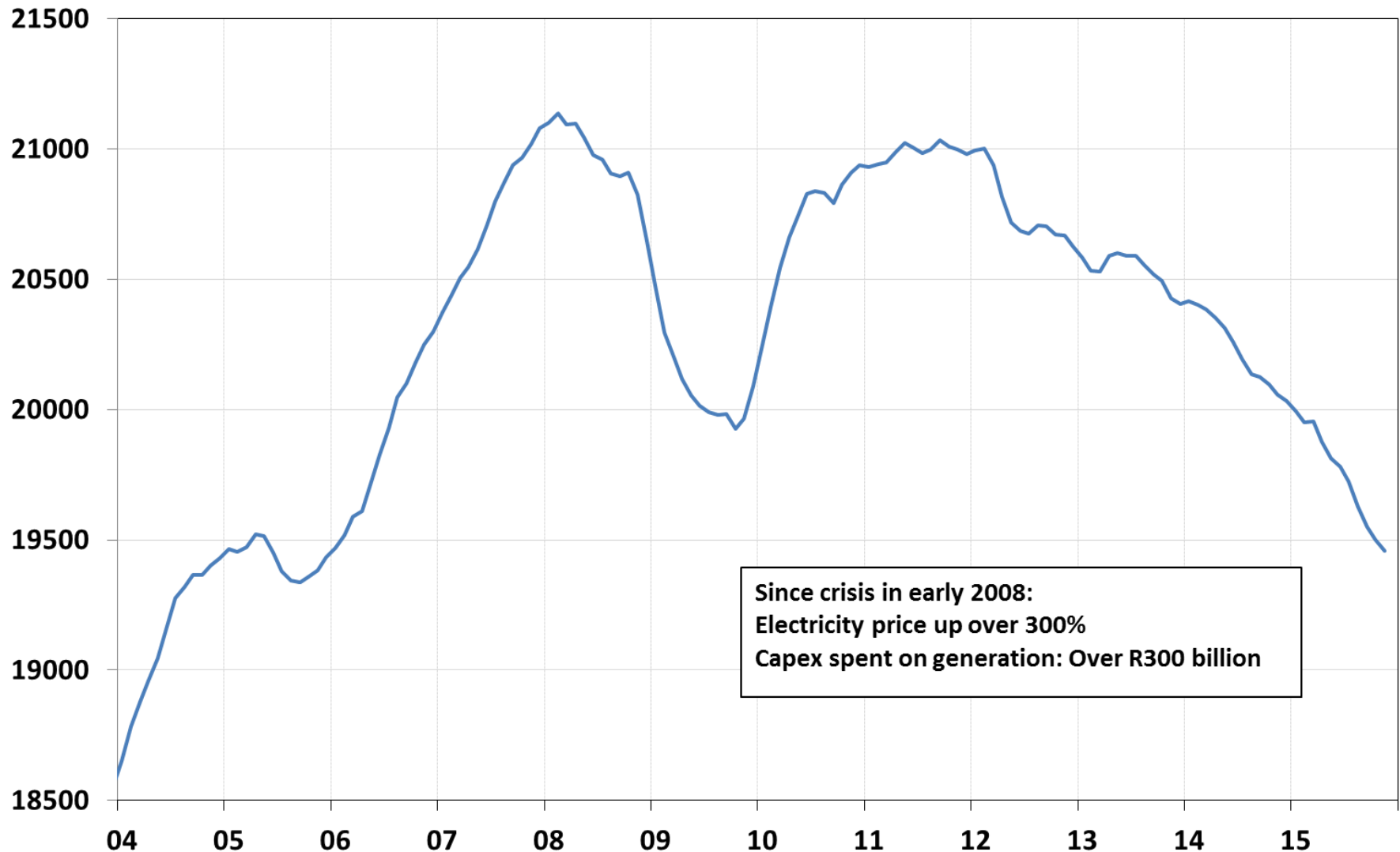
Source: Thompson Reuters

SA now produce less electricity than in 2007

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Electricity produced by Eskom: GWh (12-month moving average)

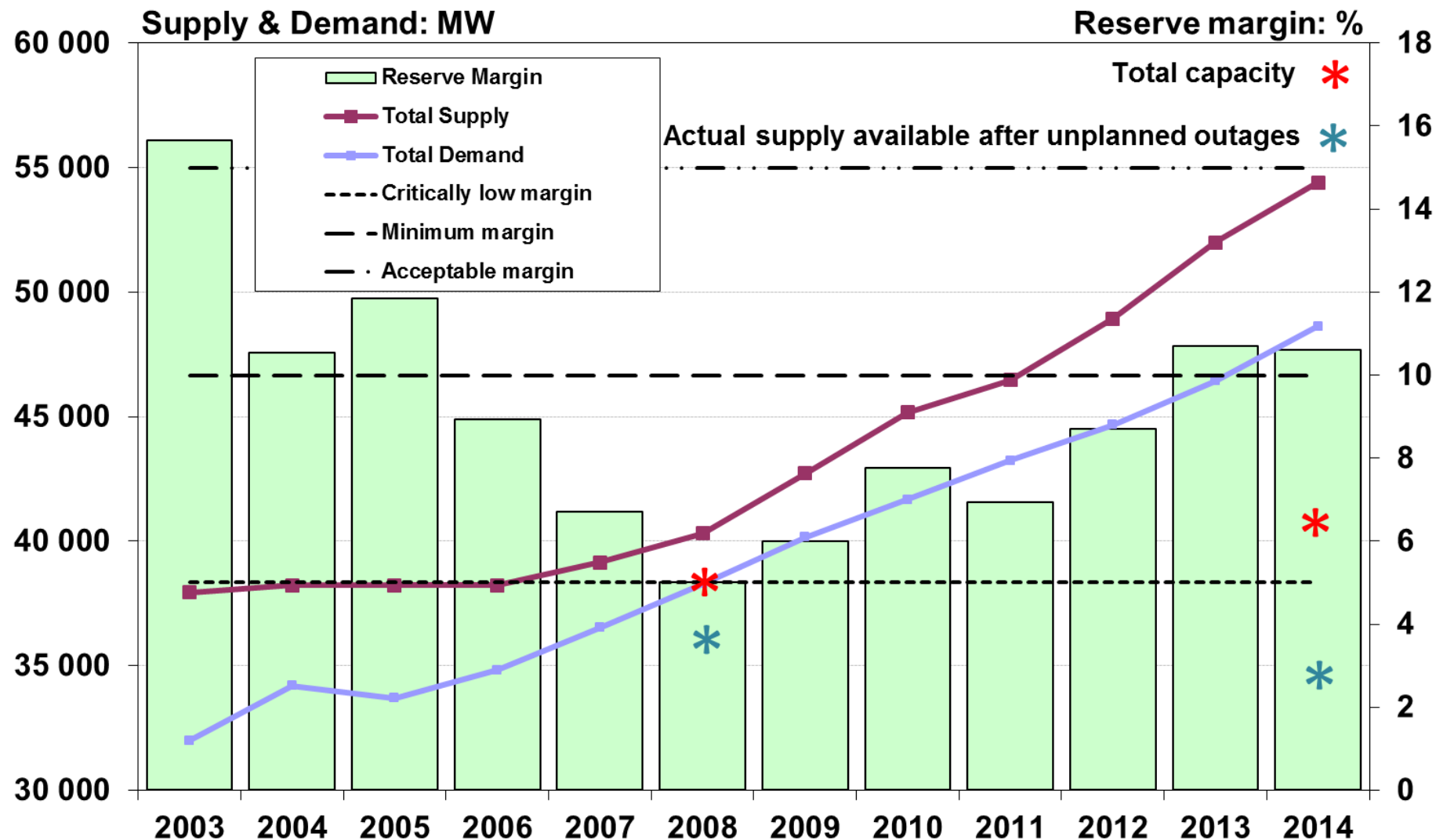


Since crisis in early 2008:
Electricity price up over 300%
Capex spent on generation: Over R300 billion

Source: Statistics SA

Unsurprisingly, electricity shortages have hurt both business and consumer confidence

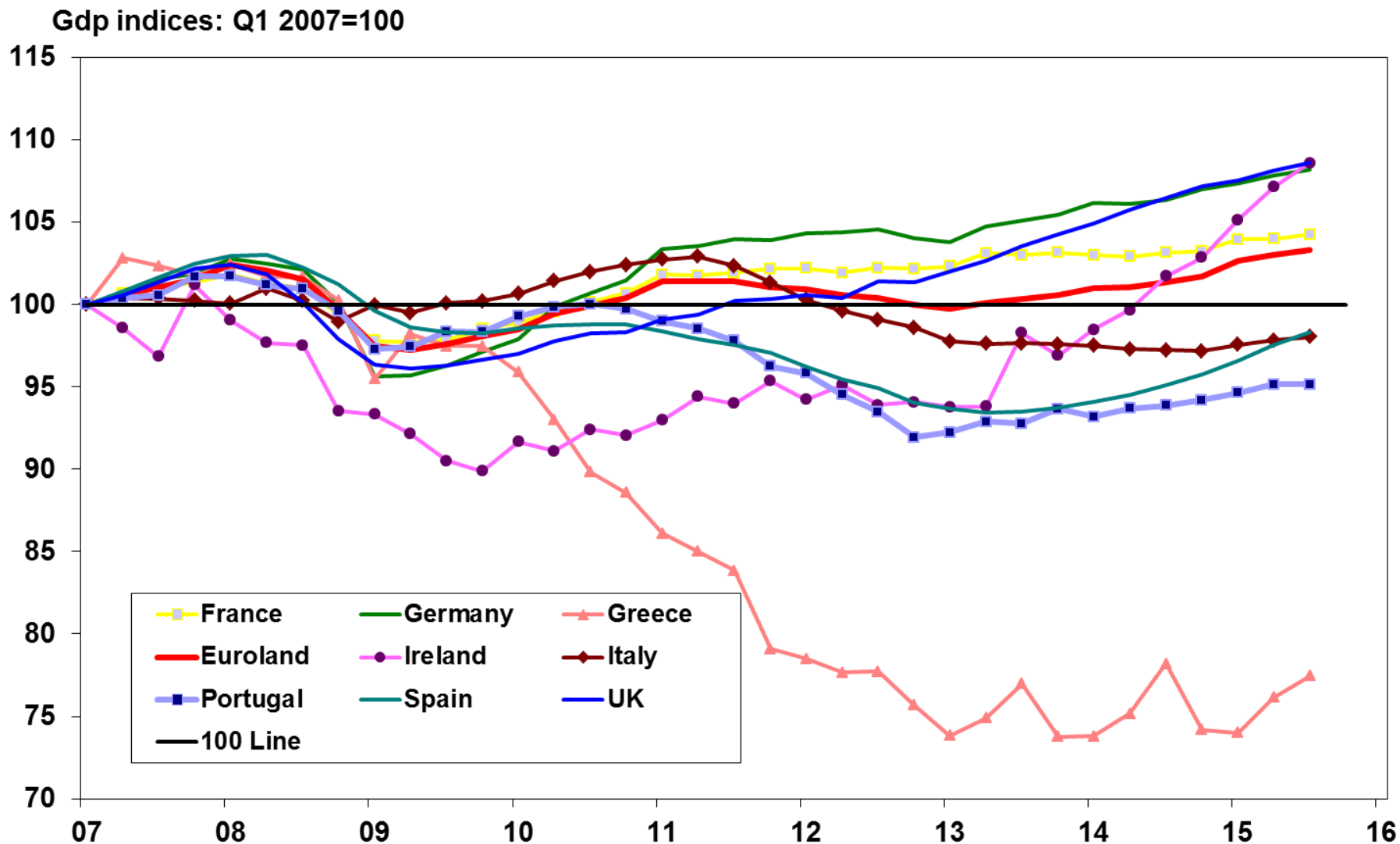
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Source: Nedbank calculations

Although the Eurozone still face considerable obstacles, the region's economy is slowly healing

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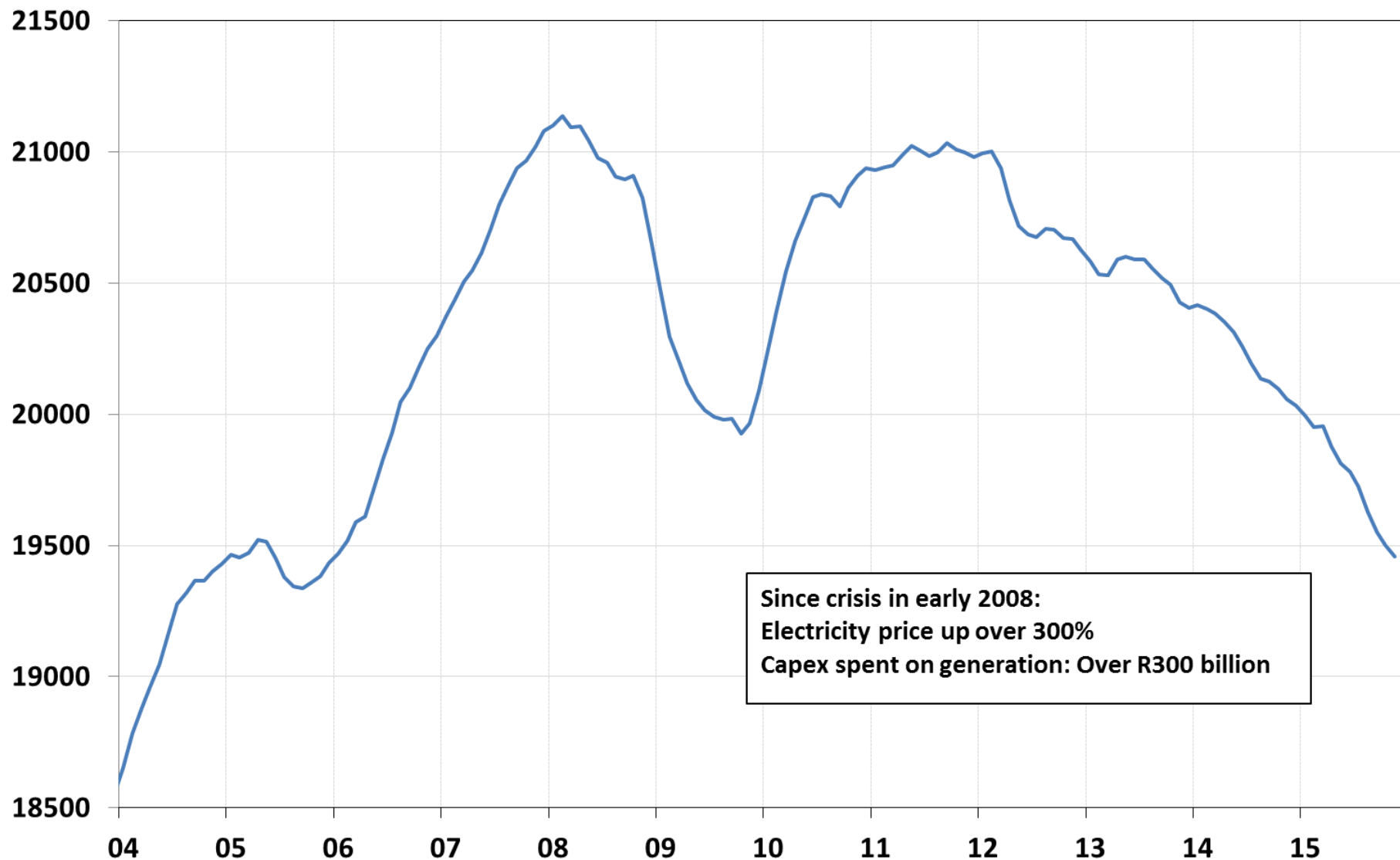
Source: IMF WEO October 2015

Despite spending over R300bn on largely two new power plants since 2008 and paying over 300% more for electricity, we produce less than in 2006

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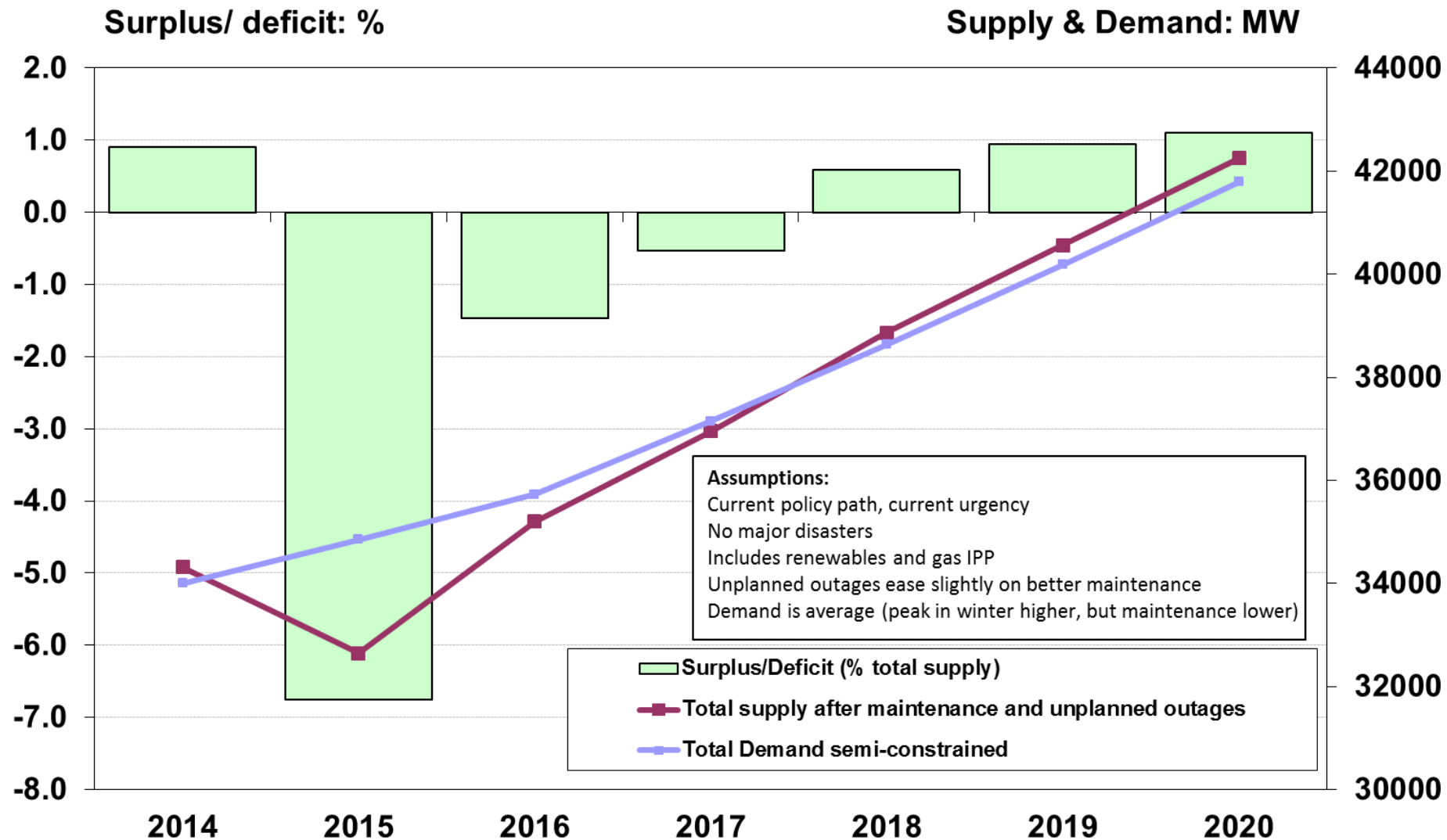
Electricity produced by Eskom: GWh (12-month moving average)



Source: Statistics South Africa

The electricity deficit is likely to persist despite slower growth

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Source: GEU calculations

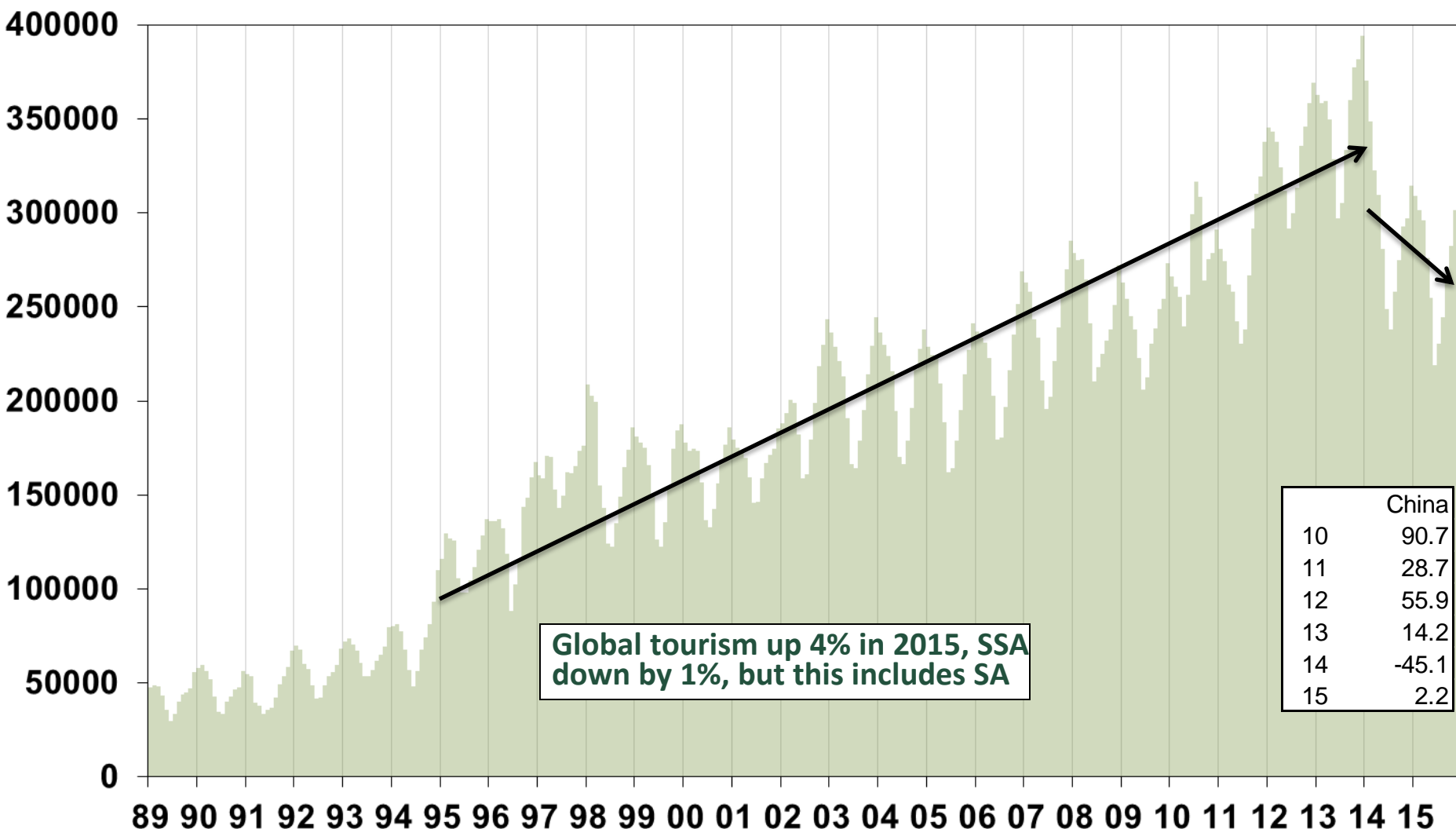
- **Mounting cost pressures and erosion of global cost competitiveness**
 - Negative relationship between cost and productivity of labour
 - Inadequate and inefficient public services, legislative burden, red tape and corruption
 - Surging costs of utilities and basic economic services – power, transport (road, rail, ports), water, telecommunications
- **Capacity constraints amplifying costs pressures & constraining expansion**
 - Lack of power generating capacity
 - Limited and ageing road, rail and port infrastructure
 - Insufficient social infrastructure – public transport, health, education, water
- **Increased policy uncertainty & political turmoil**

**Legislative and regulatory changes also to blame for weak confidence, weak activity and fading fixed investment...
One example: the visa fiasco.**

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Foreign arrivals (number 3-month moving average)



From
concern

To outright
suspicion

Weak growth

Persistent current
account deficit

Power & other
constraints

Abrupt changes in
finance ministers

Ratings
downgrades

Uncertain
economic policies

Mounting
government debt

Measurable costs of the fiasco

