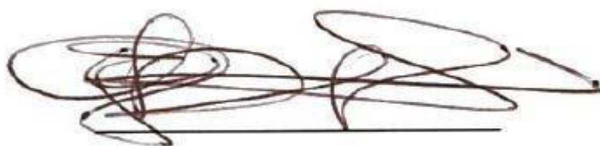
Quarterly Economic Bulletin 2017/18 Q1

Foreword

The South African economic policy framework, the National Development plan, has outlined concrete strategies to be initiated to steer the economy to a sustainable and more inclusive economic trajectory. However external and domestic shocks have made it difficult to deliver on the NDP aspirations. The plan has estimated to grow the domestic economy by an average of 5.4 percent over the period, thereby increasing GDP per capita from R50 000 to R110 000. Unemployment was to decrease from 24.9 percent in 2012 to 14 percent in 2020. The country has fall short in achieving the targets, currently unemployment stands at 26.5 percent, while economic growth was recorded to be -0.3 percent in Q4 of 2016

The Quarterly Economic Bulletin (QEB) is presented at a time when the national economy is battered by shocks that are impeding growth potential. The number of growth risks in the country require smart and urgent policy reaction to prevent the country from suffering low levels of productivity. Among other things the careful sequencing and appropriate macroeconomic support, stable fiscal and monetary policy that need to be accommodative and economic growth friendly. Although the country has adopted the fiscal consolidation stance, on the other tail end resources need to be directed on accelerating investment expenditure in economic infrastructure to support overall productivity.

The provincial economic outlook will remain suppressed due the aftermath of the protracted drought, and plague such as army worm that jeopardised maize production especially among the small emerging farmers. The drive towards industrialization necessitates ad acceleration in the development and implementation of the Special Economic Zones (SEZs) in Limpopo.



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LIMPOPO PROVINCIAL TREASURY

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1. Introduction

It is naive to think that the provincial economy is immune to the international and national political and economic turbulences. In many ways the province will suffer similar symptoms that are experience nationally, however, regional policy interventions are necessary to redress any regression experienced. For instance, the impact of the downgrading of the domestic and international dominated currency long term debt, based on reviewing national developments, however, are slowly trickling down to the provincial and even municipal level. This requires prudent fiscal management by all tiers of government to ensure sustainable economic growth and development in the country.

In the first part of the quarterly bulletin an overview will be provided on the global and national economic outlook. This will introduce the second part of the bulletin that evaluates the sovereign debt downgrade by Standard and Poor's. The evaluation will include the implications for the fiscal policy in South Africa.

2. Economic Overview

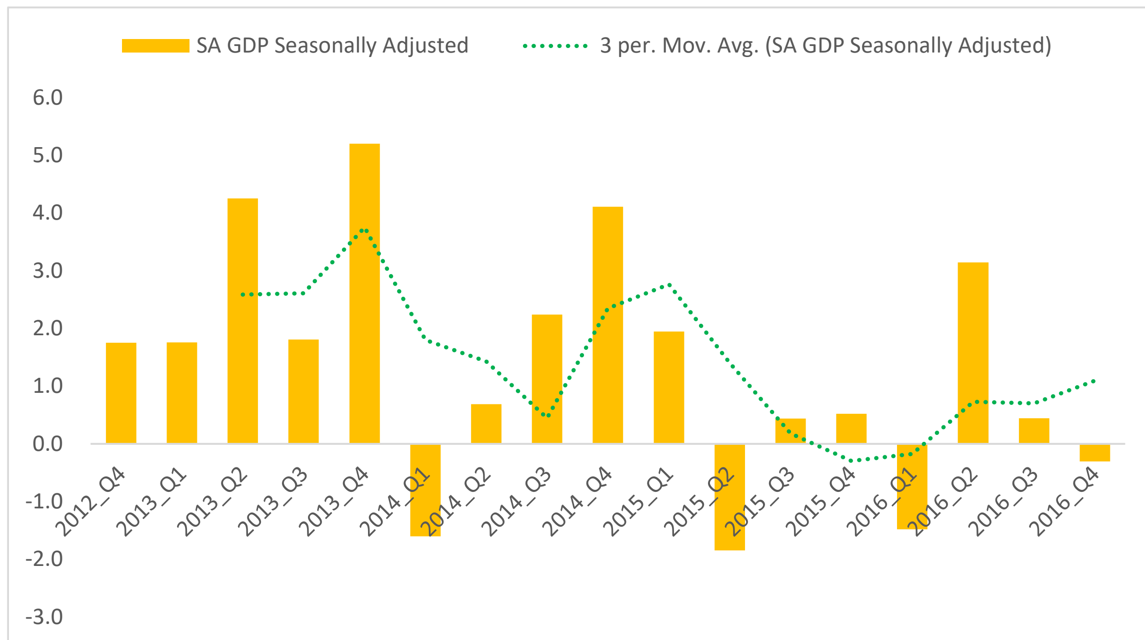
The South African economy has undergone multiple exogenous and endogenous shocks, from international trade developments to domestic political disturbances. Moreover, the macroeconomic fundamental outlook has deteriorated leading to the downgrade of foreign denominated debt of the South African Government to junk status. The lacklustre performance of the South African economy in 2016 could, to a large extent, be attributed to weak consumer demand, an acceleration in consumer price inflation, stagnant formal sector employment, persistent subdued business and consumer confidence levels that suppressed fixed investment, and the adverse effects of the prolonged drought conditions experienced in many parts of the country.

2.1. National Growth Outlook

Real economic growth in South Africa slowed further and turned negative in the fourth quarter of 2016. Real gross domestic product (GDP) portrayed in figure1 contracted at an annualised rate of 0.3 percent in the fourth quarter of 2016 following marginal

growth of 0.4 percent in the third quarter. The disappointing performance in the fourth quarter reflected a decrease in the production by the primary and secondary sectors.

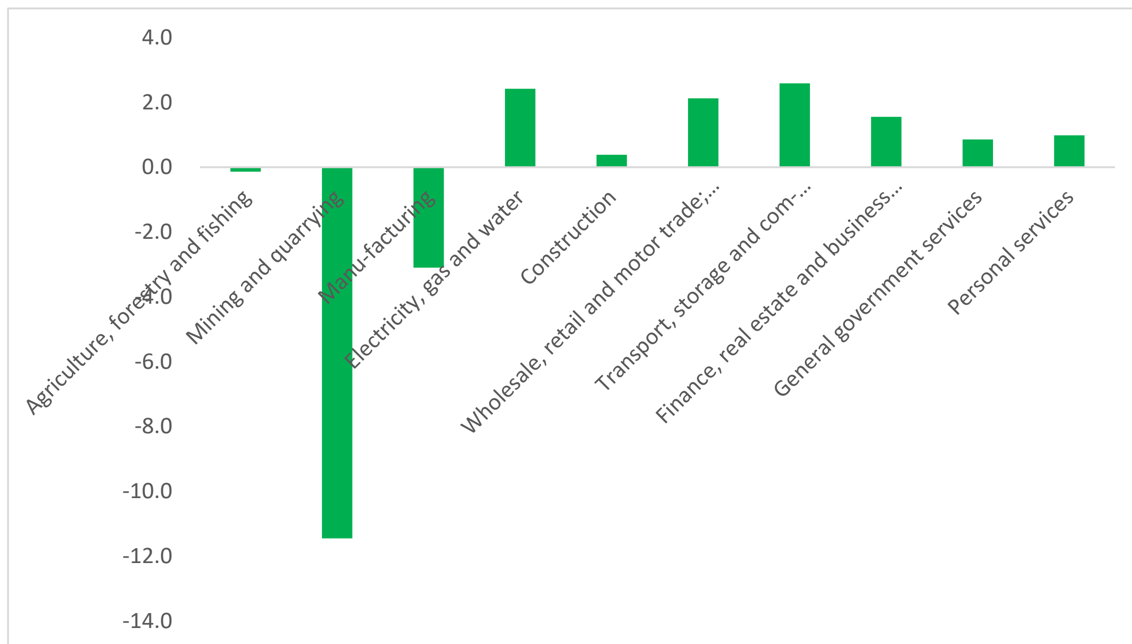
Figure 1 SA GDP Seasonally Adjusted at constant 2010 Prices



Source: StatsSA GDP 2016

The largest negative contributor to growth in GDP in the fourth quarter was the mining and quarrying industry, which decreased by 11.5 percent. This was followed by manufacturing, which decreased by 3.1 percent. The trade, catering and accommodation industry and finance, real estate and business services increased by 2.1 percent and 1.6 percent respectively. The transport, storage and communication industry increased by 2.6 percent.

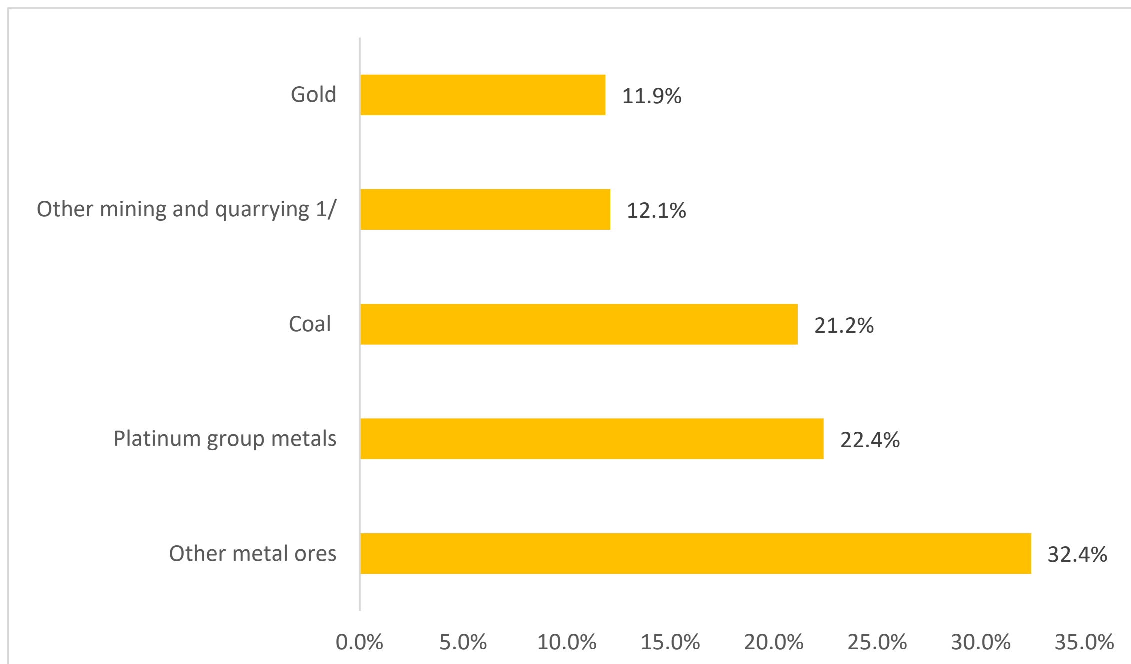
Figure 2 SA GDP Seasonally Adjusted by industry at constant 2010 Prices



Source: StatsSA GDP 2016

The largest commodity with significant contribution to national Mining and quarrying sector is Other metal ores, contributing 32.4 percent. This is followed by Platinum group metals, contributing 22.4 percent. Coal and Gold contributed 21.3 and 12.1 percent respectively. On an annual basis, real output of the mining sector contracted in 2016 as production in all mineral groups declined over the period, with the exception of building materials. Despite the increase in commodity prices, although still relatively low, the decrease in mining output could in part be attributed to low levels of confidence and regulatory uncertainty in the mining sector as well as steep increases in the operational cost of mines. This includes that tariffs hikes in electricity and increases in wages.

Figure 3 Relative contributions to national mining and quarrying in 2015

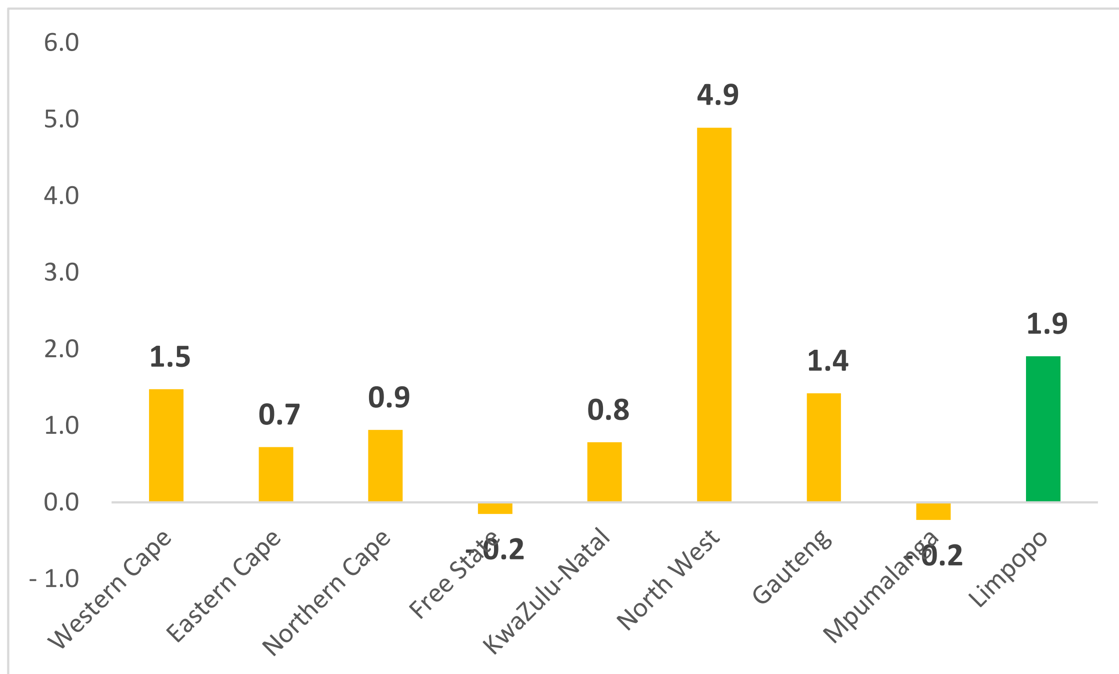


Source: StatsSA GDP 2016

2.2. Limpopo Growth Outlook

According to StatsSA, the annual real estimate of GDP for 2015 increased by 1.3 percent compared with 2014. Preliminary estimates indicate that the highest real annual economic growth rates by region – as measured by the gross domestic product by region (GDPR) at market prices – for 2015 compared with 2014 were recorded in North West at 4.9 percent, Limpopo at 1.9 percent, Western Cape at 1.5 percent and Gauteng at 1.4 percent

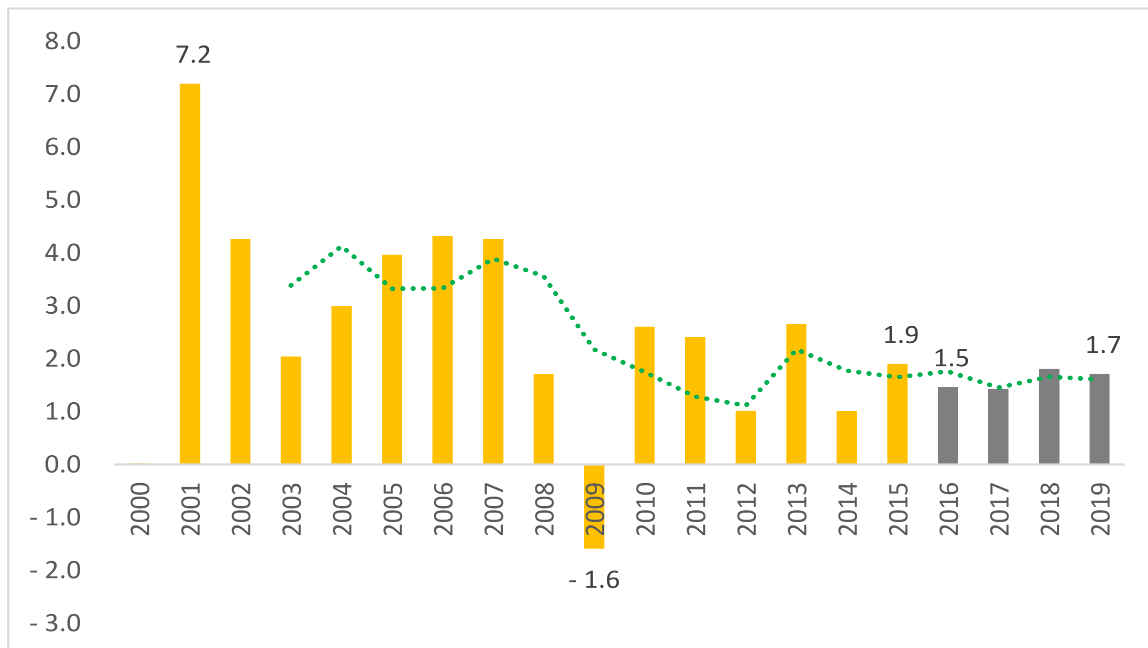
Figure 4 GDP percentage changes by province at constant 2010 Prices



Source: StatsSA GDP 2016

The Limpopo economic growth is forecast to grow at 1.4 percent in 2017 by the Limpopo Provincial Treasury and expected to improve slightly to 1.7 percent in 2019 as shown in figure 5. The forecast depends primarily on the performance of the mining sector during 2017. However, these projected growth rates are significantly lower than the anticipated 3 percent in the Limpopo Development Plan. This is due to a number of developments such as slow recovery from 2008/09 global financial growth, geo-political developments in Europe and policy uncertainty in the Trump administration and current political disturbances locally which have contributed to the local and foreign currency dominated long term debt downgrading by one of the Credit Rating Agency (CRA) Standard and Poor's.

Figure 5 Limpopo GDP percentage changes at constant 2010 Prices



2.3. Economic Growth Risks

A few of the current risks to economic growth will now be discussed. This includes the credit rating, low consumer spending and the slow expenditure on the infrastructure programme.

2.3.1. Credit rating

Any further adverse developments in the credit ratings will jeopardise the country's growth potential in several ways. Credit ratings inform business decision making, therefore adverse credit ratings will make investors to be speculative and conservative in terms of rolling out capital expenditure. This therefore limits growth in domestic productivity and job creation. Fiscal policy will also be negatively impacted. The adverse ratings raise the cost of borrowing and servicing the current foreign currency denominated debt reducing the disposal income of government. As part of the remedial action, government may be forced to implement strict fiscal consolidation measures which may include reducing expenditure ceilings. This can also include lower budget allocations to different provinces. The increased cost of borrowing is aggravating an already tight fiscal situation on national level.

2.3.2. Low consumer spending

The high inflation rates and interest rates effectively reduces the consumers spending potency. The rise in inflation on average reduces household's spending power, while high interest rates increases the cost of financial capital and servicing of debt to be high. This diverts the household's income from expenditure to servicing of debt.

2.3.3. Lacklustre expenditure on infrastructure programmes

Under spending on infrastructure programmes have a negative effect on the rest of the economy. Economic theory and empirical research suggest that investment in economic infrastructure spurs economic growth. It is also expected to generate employment directly through the actual construction, operation and maintenance requirements but also through indirect multiplier effects across the economy through its impact on the sectors that is supplying inputs to the infrastructure sector.

The impact of the downgrade by Standard and Poor's will now be evaluated.

3. Sovereign Credit Rating Outlook

3.1. Background

There are generally three credit rating agencies in the world namely Standard and Poors (S&P), Moody's Investor's Services (Moody's) and Fitch Ratings (Fitch). The extensive utilisation of the rating agencies is based on the simplicity and comparability of the agencies risk grading systems and their perceived analytical strength and independence. Investors normally use ratings in their pricing calculations, and in decisions to buy, sell or hold securities. The credit rating of a country is an indication of the risk of default on bond repayments by that country.

The sovereign rating is not just a measure of whether a country is a good investment destination but also evaluates the political, economic and financial developments that can impact of the country as an investment destination.

Lenders will generally not lend funds if their loans would be exposed to very high business or economic risks exposing them to possible default by the lender. Lenders are typically willing to bear some financial risk but they will insist on being compensated for bearing such risk. The basic principle is that higher risk will demand a higher return to compensate for the risk. It is therefore crucial for lenders and investors to invest in rating information to create a risk profile of their clients to base business decisions.

Credit ratings are the opinion of the rating agency on the relative ability and willingness of issuer of a debt instrument to meet the debt service obligations as and when they arise. Rating is usually expressed in alphabetical or alphanumeric symbols. Symbols are simple and easily understood tool which help the investor to differentiate between debt instruments on the basis of their underlying credit quality. Rating companies also publish explanations for their symbols used as well as the rationale for the ratings assigned by them, to facilitate deeper understanding.

3.2. Functions of a Credit Rating Agency

There are generally four major functions of the credit rating agency which are to:

3.2.1. **Provide unbiased opinion**: An independent credit rating agency is likely to provide an unbiased opinion as to relative capability of the company or government to service debt obligations.

3.2.2. **Provide basis for investment**: An investment rated by a credit rating agency enjoys higher confidence from investors. Investors can make an estimate of the risk and return associated with a particular rated issue while investing money in them.

3.2.3. **Support healthy discipline on corporate borrowers**: Higher credit ratings to any credit investment enhances corporate image and builds up goodwill and hence it induces a healthy/ discipline on corporate.

3.2.4. **Support formation of public policy**: Once the debt securities are rated professionally, it would be easier to formulate public policy guidelines as to the eligibility of securities to be included in different kinds of institutional

portfolio. An example of this is the Citi Bank world government bond index. The index only includes countries with an investment grade or higher.

3.3. Current rating outcomes

Standard and Poors recently decided to downgrade South Africa’s foreign denominated debt to junk status. The downgrade reflects S&P’s view of the political uncertainty in South Africa after the recent cabinet reshuffle that have put policy continuity at risk. This has increased the likelihood that economic growth and fiscal outcomes could suffer with a new Minister of Finance being appointed. The fiscal situation in South Africa is currently tight with the ratio of debt to GDP approaching 50 percent.

The rating action also reflects S&P’s view that contingent liabilities to the state, particularly in the energy sector, are on the rise, and that previous plans to improve the underlying financial position of Eskom may not be implemented in a comprehensive and timely manner. The fear also existed that the new Minister of Finance will approve the nuclear deal. The new Minister however indicated to the rating agencies that he intends to continue with the same prudent policy stance as his predecessors. In our view, higher risks of budgetary slippage will also put upward pressure on country’s cost of capital, further dampening already-modest growth.

It is for these reasons that S&P has lowered the country’s long-term foreign currency sovereign credit rating to 'BB+' from 'BBB-' and the long-term local currency rating to 'BBB-' from 'BBB'. Implying that an obligor rated 'BBB' has adequate capacity to meet its financial commitments. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitments.

Table 1 SA Currency rating

Rating Type	Rating	Rating Date	Regulatory Identifiers	CreditWatch/ Outlook	CreditWatch/ Outlook Date
Local Currency LT	BBB-Regulatory Disclosures	03-Apr-17	EU	Negative	03-Apr-17
Local Currency ST	A-3Regulatory Disclosures	03-Apr-17	EU		
Foreign Currency LT	BB+Regulatory Disclosures	03-Apr-17	EU	Negative	03-Apr-17
Foreign Currency ST	BRegulatory Disclosures	03-Apr-17	EU		
South Africa National Scale LT	zaAA-Regulatory Disclosures	03-Apr-17	EU		
South Africa National Scale ST	zaA-1Regulatory Disclosures	29-Mar-06	EU		

Source: S&P

S&P Global Ratings' analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: 1. institutional assessment; 2. economic assessment; 3 external assessments; 4 the average of fiscal flexibility and performance, and debt burden; and 5 monetary assessment. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest).

The ratings score snapshot summarizes whether we consider that the individual rating factors listed in the methodology constitute a strength or a weakness to the sovereign credit profile, or whether they consider them to be neutral. The concepts of "strength", "neutral", or "weakness" are absolute, rather than in relation to sovereigns in a given rating category. Therefore, highly rated sovereigns will typically display more strengths, and lower rated sovereigns more weaknesses. In accordance with S&P Global Ratings' sovereign ratings methodology, a change in assessment of the aforementioned factors does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the assessments.

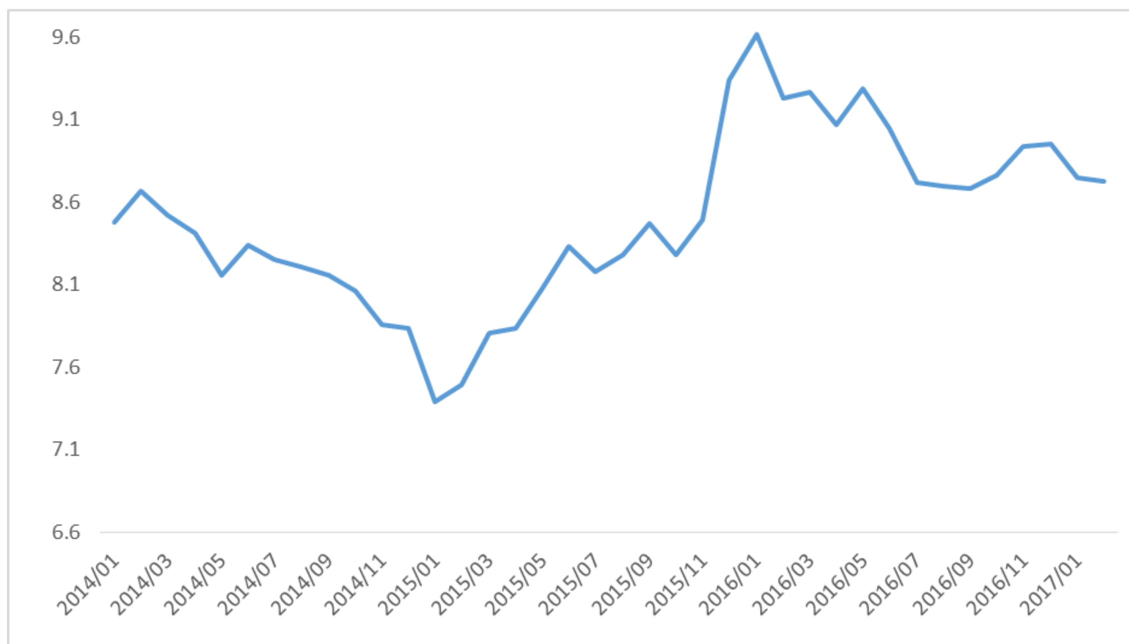
3.4. Impact of adverse credit rating

An adverse credit rating will have various negative consequences that will now be discussed.

3.4.1. **Rise in the average yields**. The downgrade is forcing big international bond funds to sell off some of their South African bonds.

Another challenge is that South Africa is a net importer of goods and services. This means we are running a current account deficit. This deficit on the current account needs to be paid for by net positive currency inflows. If the expected sell off happens it will put pressure on the Balance of Payment and lead to a possible depreciation in the value of the Rand. This will put upward pressure on the inflation rate and interest rates.

Figure 6 Yield on loan stock traded on the stock exchange: Government bonds - 10 years



Source: South African Reserve Bank (SARB)

3.4.2. **Rise in interest rates**. The South African Reserve Bank has adopted a policy regime based on inflation targeting. The Bank tries to keep the inflation rate in a target band of between 3to 6 percent. If there is cost pressure in the economy and the inflation rate is near the upper end of the target band, it will put upward pressure on interest rates. The downgrade will put upward pressure on prices in the South African economy and can lead to the Reserve bank starting to tighten interest rate sooner than expected. This will again impact negatively on the already poor growth performance of the local economy.

3.4.3. **Reduced growth in tax revenue**. Due to the recessionary environment and deteriorated macro-economic fundamentals, government may sub optimally collect tax revenue due to reduced productivity levels in the country. Subnational governments may also suffer reduced growth in national transfers.

3.4.4. **Tax increases could be on the cards**. As the government may wrestle to balance expenditure with revenue at the now higher-cost-of-lending, it is very possible that the government will raise taxes across the board.

3.4.5. **Potential job losses and lower salary increases**. Local companies may struggle to grow profits and revenue in the recessionary environment that the downgrade could place South Africa. This may result in job losses as well as a lack of salary increases or bonuses, which will further affect consumer spending.

3.5. Benefits of Credit Ratings

If a country or company can manage its credit rating it can be advantageous to that government or company.

Some of the advantages includes the following:

3.5.1. Easy to raise resources

Government or a company with highly rated instrument finds it easy to raise resources from the public. Even though investors in different sections of the society understand the degree of risk and uncertainty attached to a particular security but they still get attracted towards the highly rated instruments.

3.5.2. Reduced cost of borrowing

Investors always like to make investments in such instrument, which ensure safety and easy liquidity rather than high rate of return. Government or a company can reduce

the cost of borrowing by having a higher credit rating because the market will expect a lower return than for more risky companies of governments.

3.5.3. Rating builds up image

A government or a company with highly rated credit instruments enjoy better goodwill and corporate image in the eyes of creditors, investors, customers, and shareholders. Shareholders are sure of high returns, investors feel secured of their investments and creditors are assured of timely payments of interest and principal.

3.5.4. Rating facilitates growth

A high credit rating provides more opportunities to approach the market to raise capital to fund expansion.

4. Conclusion

The country and the province in particular is faced with various socio-economic challenges like high unemployment, people living in poverty and inequality. Therefore, it is important that South Africa obtain an investment grading as soon as possible to boost the country as a possible investment destination. The investment grading can be obtained if the country continues pursuing its current stable fiscal and monetary policy objectives.

5. Recommendations

Policy proposals that are likely to regain the investment rating includes the focus on a pro-growth fiscal framework by optimizing the expenditure on the provincial budget. The current challenge is that the majority of the biggest is spend of compensation of employees with limited scope to prioritize spending on achieving specific other growth related policy objectives. If the expenditure in the provincial budget can be optimized it can release additional money for other policy objectives than health, education and social development.

In order to support fiscal sustainability, government needs to improve efficiency in the public sector, by focusing on among other things pursuing innovative practices linked to increased productivity yet maintaining same resources, revamping or elimination programmes with less impact, improving the use of established measurement and analytical tools to generate actionable insights; and strengthening management incentives to become more efficient.

It is also important that the provincial economy is diversified away from its dependence on the primary sector of agriculture and mining towards boosting the manufacturing and service sector in the province. This highlights the importance of driving the re-industrialization of the local economy with the establishment of the SEZ's and the beneficiation of the agricultural and mining output. Promoting the tourism sector can also assist in diminishing the dependence on the primary sectors and to promote higher levels of economic growth and job creation.