On Wednesday, 24 February 2016, the Minister of Finance, Pravin Gordhan presented his first National Budget since resuming office as Minister of Finance in December 2015. As usual, the Minister tried to balance a range of competing objectives, but with an overarching need to try to avoid any further credit rating downgrades.

Consequently, the Minister delivered a very determined budget that focused on a combination of tax increases, especially a further increase in the fuel levy, and fiscal consolidation, in order to reduce the fiscal deficit to below 2.5% of GDP over the next 3 years. This meant that there were very few new spending initiatives, although there is a substantial increase in spending on tertiary education and some relief for the farming community impacted by the current severe drought.

Foreign investors and the international credit rating agencies are likely to welcome the Minister’s intention to reduce the fiscal deficit as well as contain government debt. In particular, it is clear that there is no room to accommodate another substantial rise in public sector wages. The business community is also likely to welcome key aspects of the budget including the Minister’s intention to remove barriers to business investment.

Unfortunately, the household sector, which is already under-strain, will face the bulk of government’s fiscal austerity measures. This will dampen consumer activity further in 2016.

The global economic backdrop

Global growth has remained somewhat disappointing during the past year, with increasing risks to the downside. Although the United States has maintained a solid but unexciting recovery, the Euro-area and Japan have essentially stagnated.

Amongst the major emerging economies, India continues to out-perform while China’s growth rate has slowly slid to below 7.0%. Brazil and Russia are both in recession. Emerging markets are simply not as vibrant as they were a few years ago, although there are some important exceptions, including India.

World’s largest economy is experiencing downside pressure

One of the key risks and growing concerns in the world economy is the current decline in United States manufacturing activity. This slump in manufacturing is reflected in the ISM manufacturing index, which was below the key 50 index level each month since October 2015. It is also reflected in the industrial production data, which has declined over the past year.

Historically, there has been a good correlation between the US manufacturing business cycle and the overall economic cycle of the country. However, this relationship has become less pronounced in recent years as the size of the United States manufacturing sector has dwindled. For example, back in 1997 the manufacturing sector represented just over 16% of the US economy. In late 2015 it had fallen to 12%.

Equally, United States private sector employment is no longer highly dependent on manufacturing employment. Back in early 1980s, US manufacturing employment comprised around 20% of total employment. Today it is less than 9%. This suggests a pullback in US manufacturing employment does not necessarily translate into widespread job cuts at a national level.

A combination of four key factors appears to explain most of the current weakness in United States manufacturing. Firstly, the Dollar has remained relatively strong for a considerable time. This has systematically undermined the international competitiveness of the US manufacturing sector, which has led to a noticeable fall-off in US exports. This fall-off in exports has been further aggravated by a slump in global trade.
Secondly, the sharply lower oil price has dramatically reduced the appetite for oil (shale) exploration in the US. This fall-off would have negatively impacted some components of United States manufacturing.

Thirdly, orders for durable goods (items of equipment that are designed to last longer than 3 years) are in recession. This reflects a lack of fixed investment spending/maintenance upgrades by the corporate sector. A sustained decline in durable goods orders would tend to weaken the manufacturing sector.

Lastly, the strong dollar has led to some increase in United States import volumes. A portion of the increase in imports could be undermining the growth in the United States manufacturing sector.

While the US manufacturing sector is not as vital a component of the United States economy as it used to be, it remains significant. Sustained weakness in US industrial production, especially if it is accompanied by weakness in global manufacturing activity (which is becoming a more significant concern in the world economy) could systematically weaken business sentiment in other sectors of the economy, thereby undermining their desire to expand and employ.

At this stage the risk of the United States manufacturing sector pulling the entire United States economy back into recession is considered modest, but not insignificant.

**China’s rebalancing has unsettled emerging economies, including South Africa**

China’s economic growth has slowed systematically from an annual average rate of around 11% in 2010 to an estimated 6.9% in 2015, and a forecast of 6.3% in 2016.

The slowdown in Chinese economic activity is understandable. It is partly due to the fact that the success of the Chinese economy has largely been driven by very rapid growth in manufacturing activity, a sustained increase in exports and the relentless development of housing and infrastructure, which has now left the economy unbalanced.

Consequently, the Chinese authorities have indicated that they aim to transition the country away from being an outright industrial/fixed investment driven economy into an economy that reflects a better balance between investment and consumption, including the development of the service sector. However, this is likely to be a lengthy process, with many stumbles along the way. It also suggests that China cannot provide the boost to commodity prices that it once did.

China has not devoted enough attention to the development of other key sectors of the economy, including education and healthcare. In addition, its major cities are dangerously polluted and the country has a relatively under-developed financial and retail services sector. The economy needs to re-balance in favour of the services sectors, which implies less production and more consumption. Without this rebalancing, China’s economy will continue to lose momentum and start to stagnate.

China’s intention to reform their economy is reflected in their recent decision to devalue their currency, after years of sustained currency appreciation. It can be argued that the devaluation is relatively modest (-6.5% since August 2015) and probably partly in response to concerns about slowing growth as well as the PBOC’s intention of shifting to a more flexible, market-based exchange rate. However, the devaluation has unsettled financial markets, raising concerns about the extent of the economic slowdown in China as well as the risk of China sparking currency wars.

At this stage, it seems fair to assume that Chinese Yuan (CNY) will depreciate further in the months ahead, but that the decline is likely to be modest and gradual. It also seems fair to argue that the market will have to adjust to a new way in which the PBOC will determine the reference rate for the currency, and there is the possibility that the trading band for the CNY will be systematically widened.

While it can be argued that many of the mature economies are relatively resilient to the sustained economic slowdown in emerging markets, the sluggish performance in emerging markets does have consequences. One key concern is that the slowdown in China is adding to global disinflationary pressures through the impact on both lower commodity prices (including oil) and manufactured goods prices. And while the weakness in emerging economies is not sufficient to push the global economy into recession, the expectation is that world growth will again be below 3% in 2016, for the fifth consecutive year.

**South Africa’s economy on the cusp of a recession**

The South African economic environment has been challenging. The growth rate has slumped to around 1% a year; the unemployment rate remains exceedingly high at about 25%; export revenues are under pressure due to lower commodity prices; domestic confidence levels have plummeted and private sector fixed investment has stalled. Worryingly, the primary and secondary sectors of the economy, namely agriculture, mining, manufacturing, construction and electricity, are in recession on a combined basis. The weakness in South Africa’s industrial output reflects a wide range of factors including problems with low productivity, regular labour market disruptions, high import intensity, weak business confidence and infrastructure bottlenecks, especially electricity.
The manufacturing sector is effectively in recession. There is clearly a concern that the weakness in the manufacturing and mining sectors leads to increased job losses, which then would lead to a further weakness in the broader business sector, forcing the economy closer and closer to an outright recession.

SA’s growth prospects

Looking ahead, the South African economy is forecast by STANLIB to achieve a growth rate of only 0.5% in 2016, with risk to the downside, considering the severity of the current drought. This compares with an estimated growth rate of 1.3% in 2015 and an average growth rate of 2.3% since the global financial market crisis. By comparison, in the ten-year period from 1999 to 2008, South Africa achieved an average GDP growth rate of 4.0%.

National Treasury has once again revised down their growth forecasts. For 2016, the government is expecting GDP growth of only 0.9%, well down on earlier estimates. The growth outlook for 2017 has also been revised significantly lower to 1.7%, while the economy is expected to grow by 2.4% in 2018.

Worryingly, the National Treasury has also revised down its forecast of fixed investment spending in 2016 to an extremely modest 0.3%, rising fractionally to 1.4% in 2017 and 2.7% in 2018. Government’s more pessimistic outlook for investment activity largely reflects the weakening global environment, especially the fall-off in commodity prices, ongoing electricity outages, weak business confidence as well as the lack of development in most other areas of infrastructural development.

SA’s credit ratings

South Africa’s international credit ratings were recently downgraded by Fitch, Moody’s Investor Services and Standard and Poors. We have also been put on negative watch by two of these agencies. Should South Africa’s economic environment not improve, the country’s credit rating could be lowered to “junk” status. The actions taken by the rating agencies reflect their expectation of lacklustre GDP growth in South Africa, against a backdrop of a relatively high current account deficit, rising general government debt, and a deterioration in the social fabric of the country.

The decision by the rating agencies to revise down South Africa’s credit rating outlook was not a surprise, given that the economic and policy environment has clearly deteriorated.

It can also be argued that the latest ratings decisions are now largely priced-into South Africa’s financial markets. However, the country remains highly reliant on attracting foreign portfolio investment to fund the perpetual savings shortfall. This means the currency, inflation, interest rates, debt levels and growth rate are all extremely vulnerable to sudden halt in foreign capital inflows, or worse, a significant rise in foreign capital outflows.

The local exchange rate

The rand depreciated by 25.4% against the US dollar in 2015. This makes it the third worst performing emerging market currency in 2015 after the Argentinian peso (-34%) and the Brazilian real (-33%).

Furthermore, in the past five years since end 2010, the rand has weakened by 57.2% against the US dollar. This is the fourth worst performance by an emerging market currency over the five year period.

A number of factors have contributed to the recent (2015) depreciation of the Rand, both international and domestic. Domestically, the country has been beset by policy uncertainty, credit rating downgrades, a worsening of public sector finances (especially amongst public corporations), a sustained large current account deficit despite slowing economic growth, and a deterioration in the terms of trade.

Internationally, emerging economies have increasingly struggled to attract and retain foreign investment. This is partly due to the start of monetary policy normalisation in the US, but it also reflects concerns about financial market valuations in many emerging markets.

The fair-value for the rand is estimated to be around R10.95 to the US dollar. This does not mean that the rand is expected to strengthen back down to that level. Instead, it is more likely that SA’s inflation rate will systematically rise and could start to breach the upper-end of the inflation target more regularly. This would, indirectly, act to re-establish the rand’s fair value.

Lastly, although the rand is considered to be significantly under-valued, it remains under pressure. This pressure reflects the risk of further credit rating downgrades (June 2016), weak commodity prices, the country’s increased import intensity, and ongoing emerging market risk aversion by many international investors.

Nevertheless, we currently expect the rand to end 2016 somewhat firmer. This assumes that the dollar weakens meaningfully against the euro during the year. In addition, it is possible that foreign investors revisit their valuation assessment of South African fixed-interest instruments once Pravin Gordhan has started to re-establish National Treasury’s commitment to fiscal discipline.

Hopefully the recent rand weakness will systematically start to encourage local retailers to source more of their products domestically, thus helping to lift and expand South Africa’s manufactured exports. South Africa’s import and export performance needs to be closely
monitored in order to assess whether the sustained rand weakness will force to the economy to re-balance and not simply lead to higher imported inflation.

**Inflation increasing**

For 2015, South Africa’s inflation rate averaged an impressive 4.6%. However, there are concerns about a sharp upward trend in South Africa’s inflation rate during 2016, and STANLIB expects inflation to average 6.7% for the year as a whole, ending 2016 at 8.0%.

This expected increase in inflation is due to a combination of factors, namely: unfavourable base effects; a sharp increase in food inflation as a result of drought conditions and weaker exchange rate; higher electricity and water prices; a further increase in excise duties and the fuel levy in the 2016 National Budget; and an increased pass-through impact on inflation of the weaker exchange rate.

Our inflation forecast model suggests that the risk of higher inflation in 2016 could manifest more noticeably in the second half of 2016.

**Interest rates on the rise**

In 2015, the SA Reserve Bank became concerned about a broadening of inflationary pressure and decided to increase interest rates by a further 25bps in November. While this was partly in response to concerns about inflation, it also reflected their worry about South Africa’s vulnerability to foreign capital outflows, should the Federal Reserve decide to start to normalise interest rates. They followed this with a further hike of 50bps in 2016.

Given our outlook for South African inflation, it is anticipated that the SA Reserve Bank will continue to increase interest rates in 2016. At this stage the Repo rate is forecast to end 2016 at 7.50%.

Ultimately, it is critical that South Africa’s economic policy leaders find a way to lift growth and encourage business investment. Realistically, this is most likely to be achieved through a firmer implementation of the NDP, targeted infrastructure development – both hard and soft infrastructure – as well as labour market reform and stability. Government should increasingly adopt a more practical approach to resolving key infrastructural bottlenecks, including the use of private/public partnerships.

**Standard and Poor’s rationale for putting South Africa on credit watch**

On 3 December 2015, Standard and Poor’s (S&P) Ratings Services decided to revise the outlook for South Africa’s international credit rating from stable to negative. This effectively means South Africa is on credit watch. The actual rating has been maintained at BBB-, which is only one notch above speculative grade (“junk status”).

This was worse than market expectations, which expected S&P to keep their rating unchanged and maintain a stable outlook. On 13 June 2014, Standard and Poor’s had downgraded South Africa’s credit rating to BBB-. The negative outlook primarily reflects S&P’s view that the South African economy is constrained by lacklustre reform efforts, low GDP growth, volatile sources of financing, a structural and large current account deficit, and sizable general government debt.

The reasons provided by S&P for placing South Africa on credit watch are clear and hard to dispute. S&P highlighted that they could lower the ratings if GDP growth does not improve in line with their current growth expectations, or if state-owned enterprises require higher government support than they currently expect. They also have concerns about the funding of the country’s external imbalances (current account), especially if the imbalance increases.

While S&P have acknowledged the government’s commitment to fiscal prudence and an expectation that the growth rates will improve once the electricity constraint is relieved, the downside risks have increased. The most notable deterioration is the slowing growth, as well as the increased fiscal burden created by many of the public corporations.

More positively, S&P indicated that they could revise the outlook back to stable if they observe “policy implementation leading to improving business confidence and increasing private sector investment, and ultimately higher GDP growth”.

**South Africa’s budgeting process remains exceptional by global standards**

The Open Budget Index (OBI) is the world’s only independent, comparative measure of central government’s budget transparency. The OBI assigns countries covered by the Open Budget Survey a transparency score on a 100-point scale. The survey focuses specifically on whether the government provides the public with timely access to comprehensive information in accordance with international good practice standards.

According to the findings of the latest survey (2015), the most transparent countries, in order of ranking, are New Zealand, Sweden, South Africa, Norway and the United States. These countries make extensive information publicly available, as required by generally accepted good public financial management practices. They all scored above 80 out of a possible 100 points. In South Africa’s case, this exceptionally high
ranking is clearly directly related to the excellent work done by National Treasury.

South Africa’s ranking of third in the world has to be loudly applauded, despite the fact that the ranking has slipped from first in 2010 and second in 2012.

Restricting access to information hinders the ability of the public, economists, journalists, commentators, academics, and civil society organisations to hold officials accountable and creates opportunities for governments to hide unpopular, wasteful, and corrupt spending. Lack of information also hinders the ability of other government bodies, such as legislatures and national audit offices, to do their jobs effectively. Evidence shows that when citizens have access to information and opportunities to participate in the budget process they are able to improve the decisions made about what to spend public money on and the quality of how the money is actually spent. That means that the allocation of scarce public resources is more equitable and effective.

South Africa’s National Treasury stands-out as one of South Africa’s key success stories, delivering a high level of transparency, consistency, insight, strategic thinking and all-round excellence over many years.

### The budget numbers

For the 2015/16 fiscal year the Minister of Finance expects the budget balance to have recorded a deficit of 3.9% of GDP. This is slightly worse than the 3.8% the Minister projected in the October 2015 MTBPS, largely as a result of a revenue shortfall. The deficit is then expected to decline to 3.2% of GDP in 2016/2017, before falling sharply to 2.8% of GDP in 2017/18 and a mere 2.4% of GDP in 2018/19.

It should be mentioned, however, that a significant part of the reduction in the fiscal deficit in 2016/2017 is due to a sharp reduction in the transfers to other members of the Southern Africa Customs Union (SACU) to the extent of almost R12 billion. This could become problematic for regional stability.

Overall, while the reduction in the budget deficit over the next three years reflects an intention to adhere to fiscal discipline, South Africa’s National Treasury has developed a reputation in recent years for not being able to achieve the intended reduction in the fiscal deficit.

### The revenue side of the budget

Total government revenue is budgeted to increase by 8.3% in 2016/2017. This appears largely achievable, compared with the revenue growth of 11.2% in 2015/16, despite economic growth softening to less than 1.0%.

However, it is worthwhile noting that tax revenue is budgeted to rise by a more ambitious 9.8% over the coming year, which does appear over-optimistic given the low growth environment.

The composition of tax revenue is not expected to change significantly over the coming year, with the bulk of the revenue still being derived from direct taxes in the form of personal income tax (38% of total) and company tax (17.1% of total).

Revenue from indirect taxes, such as VAT and the fuel levy have grown steadily over the years (despite the VAT rate remaining unchanged at 14%) and now comprise an indispensable component of tax revenue. In fact, the revenue received from VAT (25.9% of total) consistently and significantly exceeds corporate tax receipts, with 2016/2017 no exception.

The Minister announced a fairly large number of tax changes in the budget, but avoided any adjustment to the VAT rate, corporate tax, and the top marginal tax rate for individuals. There was also, unsurprisingly, no adjustment to exchange control. Instead, the largest tax change was an adjustment to the thresholds and tax brackets applicable to individual income tax, and a 30c/l increase in the fuel levy.

There was also an increase in capital gains tax, a rise in transfer duties for properties worth more than R10 million, and the “normal” increase in excise duties. This was done to alleviate some of the fiscal pressure the government is under to contain the fiscal deficit.

The increase in the fuel levy is expected to raise an additional R6.8 billion in revenue, which is very substantial and will easily offset the modest adjustment the Minister made to the alleviation of fiscal drag on personal income tax as a result of “bracket creep” impact of inflation.
Overall, the Minister avoided a substantial increase in taxes, but it is clear that tax revenue is under pressure and that government will most likely have to raise taxes further over the coming years if economic growth and employment do not improve.

It is also clear that, for the moment, the fuel levy is being used as an alternative to increasing the VAT rate. However, this cannot be sustained indefinitely and that ultimately the government will have to seriously consider raising the VAT rate. The average VAT rate in emerging markets is around 18% compared with 14% in South Africa.

The expenditure side of the budget

Over the next three years the Minister is projecting average expenditure growth of only 7.1% a year. This is relatively moderate and only slightly above inflation, suggesting that government is focused on becoming significantly more disciplined. This focus on fiscal discipline is reflected in the fact that the government intends to reduce its expenditure ceiling by an impressive R25 billion over the next three years, compared with the October 2015 Medium Term Budget Policy Statement (MTBPS).

Key areas of growth in government spending during 2016/2017 remain education, welfare (social grants), health, housing and community development.

The Minister specifically highlighted that the government has allocated an additional R31.8 billion to support higher education over the next three years. This is clearly in response to the “fees must fall” campaign by university students.

The Minister has also indicated that government will support the farming community heavily impacted by the current drought.

Encouragingly, the government will endeavour to improve the funding for state-owned entities, including a greater involvement by the private sector as well as the disposal of non-essential assets. There is also an intention to make greater use of Private/Public Partnerships (PPP) to develop the coal and gas energy sectors.

At the same time, salary increases are to be contained, while new hiring will be more strictly controlled.

It is very encouraging to see the National Treasury announce that it will be reviewing all contracts above R10 million across government. This is being done in a quest to ensure value for money and reduce wastage and irregularities in procurement. The primary focus of this review is on all State-Owned Companies (SOCs) such as PRASA, Eskom, Transnet, SABC and South African Airways. The coal contracts of Eskom also fall within the category of contracts that are above R10 million.

Unfortunately, there is still not enough in the budget to directly promote job creation. South Africa’s unemployment rate remains far too high by historical and international standards, and clearly contributes much of the social tension and anguish experienced in South Africa on a daily basis. Increasing employment in South Africa has to be the number one economic/political/social objective.

Job creation is not merely a function of the cost of capital or even the cost of labour. A range of important policies play a crucial role in facilitating job creation, including labour regulation, education (skills development), competition policy (regulation of industry), industrial policy, trade policy, and infrastructure development. Importantly, the international credit rating agencies have flagged the lack of comprehensive growth strategy as one of their major concerns.

South African government has become a lot more indebted

While South Africa’s public sector debt parameters remain very acceptable by world standards at around 50% of GDP, the total debt as well as the cost of servicing that debt is clearly on the rise. For example, back in 2009, government’s gross debt totaled only 26% of GDP.

If left unchecked, government debt will quickly become a major hindrance to achieving many vital policy objectives. Already the cost of debt exceeds the total budget allocation to public order and safety and is one of the fastest rising components of state spending.

The higher the debt, the higher the interest cost associated with that debt. In South Africa’s case, the interest cost of state debt is projected to rise to over R154 billion in 2016/2017 or 10.7% of total government expenditure. This compares with only R88 billion (8.8% of total expenditure) as recently as 2012/2013.

Conclusion

The deterioration in South Africa’s fiscal parameters over the past few years, coupled with systematic downgrade of South Africa’s credit rating, is extremely unfortunate and troubling. Encouragingly, there is a clear intention on the part of the Minister of Finance to contain the overall increase in expenditure through a lowering of government’s expenditure ceiling as well as improvement in the efficiency of existing expenditure.

The size of government debt at around 50% of GDP remains a significant concern, especially in a rising inflationary and interest rate environment and against a backdrop of successive credit rating downgrades. Consequently, it is critical that government’s expenditure ceiling
is not breached, the public sector wage increase is contained and that a concerted effort is made to raise South Africa’s growth rate through the encouragement of private sector business.

The proposals to restructure and revamp the State Owned Enterprises also need to gain traction very quickly, while the Minister’s intention to “address institutional and regulatory barriers to business investment and growth” needs to be implemented.

Overall, the tone of the budget was very welcome. The Minister was clearly determined to avoid any further credit rating downgrades. However, the various state departments are going to have to demonstrate their political will to achieve the necessary fiscal reforms.

Lastly, as we have mentioned on numerous occasions, South Africa’s policy officials will increasingly need to focus on implementing measures that ultimately grow the economy and encourage employment in order to broaden the tax base. This will have to increasingly involve the private sector. Without a rapid and sustained rise in tax revenue, it is going to become increasingly difficult for the South African government to meet all the needs of the country.

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