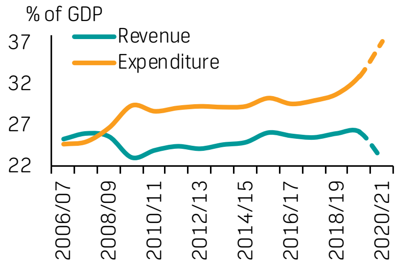
26 June 2020

Economics Weekly.

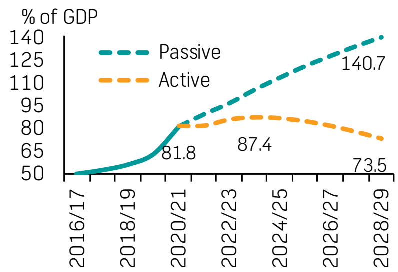
South Africa's Supplementary Budget

Figure 1: Main budget revenue and expenditure



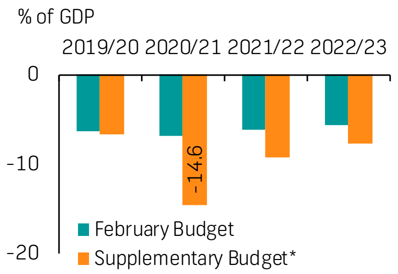
Source: National Treasury

Figure 2: Debt outlook scenarios



Source: National Treasury

Figure 3: Main budget balance



Source: National Treasury

** Based on NT's active scenario.*

The Supplementary Budget was tabled to adjust for the Covid-19 related tax revenue shortfall as well as the fiscal response to the pandemic. In short, it's a "bridge" to the Medium-Term Budget Policy Statement (MTBPS) – clearly recognising that the country faces a serious fiscal sustainability problem but, unfortunately, without providing exact details on how the government is planning to achieve debt stabilisation. October is shaping up to be a make-or-break budget event.

The highlights of the budget include:

- Real GDP contracting by 7.2% in 2020, with a recovery projected to settle at 1.5% in 2022. Without providing specifics about the "how to get there", National Treasury (NT) is optimistic this forecast might even be exceeded in two years' time.
- The deep recession results in tax revenue collapsing by R304 billion in 2020/21. Additionally, expenditure exceeds original estimates by R36 billion (mainly on account of Covid-19 relief), taking the main budget deficit from 6.8% of GDP projected four months ago to 14.6%.
- Besides the expected rebound in GDP growth, an expected improvement in tax collection and R40 billion of planned tax increases over the next three years, it will also take R230 billion of expenditure cuts (over and above the medium-term reduction of R160 billion to the wage bill set out in the 2020 Budget) to see the budget deficit fall to 7.7% of GDP in 2022/23.
- Subject to these economic growth projections and fiscal consolidation measures materialising, debt should stabilise at 87.4% of GDP in 2023/24.

Macroeconomic assumptions

NT revised its real GDP, inflation and nominal GDP forecasts lower to incorporate the serious global as well as domestic economic implications of the Covid-19 shock. While its growth projections are similar to ours for 2020/21, they are more optimistic than we are in the outer years where we continue to see significant risk of economic underperformance and fiscal slippage.

Revenue

Unsurprisingly tax revenue is expected to collapse, falling by an estimated R304 billion in 2020/21 relative to the February Budget estimate. This shortfall includes tax relief measures amounting to R26 billion in foregone revenue as part of the Covid-19 relief package. Consequently, around R280 billion of the shortfall can be attributed to collapsing economic activity as businesses fold, unemployment rises, the property market slumps and international trade volumes shrink.

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Besides relying on a rebound in nominal GDP growth, NT also bargains on planned efficiency gains in revenue collection and tax increases of R5 billion in 2021/22, R10 billion in 2022/23, R10 billion in 2023/24 and R15 billion in 2024/25, to help boost tax revenue in the future. Importantly, the 2020 MTBPS will revisit these projections, and the minister will announce tax policy proposals in the February 2021 Budget.

Expenditure

Non-interest expenditure will be R36 billion higher in 2020/21 than first anticipated. This amount consists of R145 billion added to spending for the fiscal response to the pandemic ranging from additional support to municipalities, other front-line services and support to vulnerable households, to an equity injection into the Land Bank. Partially offsetting these expenditure increases are spending reductions of R109 billion. These mainly originate from national departments' baseline suspensions and the repurposing of provincial equitable and conditional grants.

But spending cuts are not only limited to this year. Indeed, the Supplementary Budget highlights additional reductions of R230 billion on top of the proposed R160 billion reduction in the public-service wage bill set out in the 2020 Budget to help consolidate the fiscal deficit over time.

Table 1: Main budget non-interest expenditure increases

Expenditure item (R billion)	2020/21
Support to vulnerable households for 6 months	40.9
Health	21.5
Support to municipalities	20.0
Other frontline services	13.6
Basic and higher education	12.5
Small and informal business support, and job creation and protection	6.1
Support to public entities	6.0
Other Covid-19 interventions	1.8
Allocated for Covid-19 fiscal relief package	**122.4**
Land Bank equity investment	3.0
Provisional allocations for COVID-19 fiscal relief	19.6
Total	**145.0**

Source: National Treasury

Budget balance

All told, this year's main budget deficit stands to increase from 6.8% of GDP projected in February to 14.6%, before narrowing to around 7% over the medium term in order to help stabilise debt at a now much higher 87.4% of GDP in 2023/24. In 2019/20 gross national debt came to 63.5%. The projected increase in debt-service costs is quite extraordinary, rising from around 15% of main tax revenue in 2019/20 to around 21% in 2020/21.

The document highlights that in the absence of economic reform and if the proposed consolidation measures fail, debt would quickly spiral beyond 140% of GDP.

Funding the shortfall

Since February 2020, the gross borrowing requirement has increased by R344.2 billion to R776.9 billion. In order to moderate its domestic borrowing, government will draw down sterilisation deposits (money deposited at the Reserve Bank to offset excess market liquidity resulting from the purchase of foreign currency reserves). It will also source funding from international financial institutions. The proceeds from international loans will be converted into rands to partially finance domestic commitments. Short-term borrowing will increase by R98 billion to R146 billion in 2020/21, and will average R60 billion over 2021/22 and 2022/23. Borrowing in the domestic bond market will increase by R124.8 billion in 2020/21 to R462.5 billion, and average R419.9 billion over the next two years.

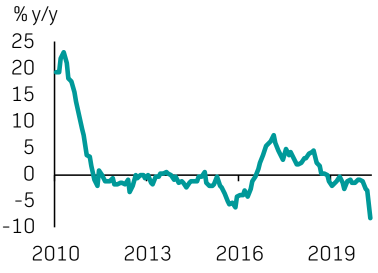
Market reaction

This budget certainly seems more bond-friendly than equity-friendly as no immediate increases in the overall size of bond issuances are expected over and above what was already planned and a commitment to running a primary surplus in 2023/2024 will be positively received by debtholders. Yields came down slightly across the curve after the speech. The rand depreciated to R17.40 on Wednesday as the budget was tabled but had again strengthened to within the day's trading range towards the end of the day. The equity market ended lower, in line with global markets. Lower consumption expenditure by government and the hinting of potential tax increases to come will be negative for the equity market in the short to medium term. A commitment to structural reform and an ambitious infrastructure programme could boost growth longer term, which will have an ultimately beneficial impact on the market if executed.

Weekly highlights

SARB leading indicator continues to fall

Figure 4: SARB leading indicator



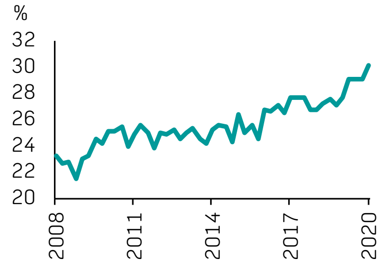
Source: EconoStat, SARB

The South African Reserve Bank (SARB) leading indicator fell 5.1% m/m in April after retreating 0.9% in the previous month. Seven of the nine available indicators declined over the month as the downturn was led by a fall in passenger vehicle sales and *Sunday Times* job advertisements. The only positive indicators over the month were the interest rate spread and the real M1 money supply.

On a year-on-year basis, the index has contracted for 18 consecutive months, plunging 8.2% y/y in April – the steepest decline since August 2009. The overall trend in the SARB leading indicator continues to be reflective of our full-year GDP forecast of a contraction of 8% as lockdown restrictions continue to adversely impact economic activity.

Unemployment rate climbs higher

Figure 5: Unemployment rate



Source: EconoStat, Stats SA

South Africa's ***Quarterly Labour Force Survey*** (QLFS) revealed that the unemployment rate climbed to 30.1% in the first quarter of the year from 29.1% in the previous quarter. This was the highest rate on record. The number of unemployed labour market participants rose by 344 000 over the quarter (+5.1% q/q and +14% y/y) to 7.1 million individuals. The finance (-50 000) and community social services (-33 000) sectors made up the lion's share of job losses, while surprisingly the trade sector added 71 000 jobs in 1Q20. We suspect that the latter has declined sharply in 2Q20 amid several closures in the leisure and hospitality industry during the lockdown. We also anticipate that there has been job losses in the retail sector with the abrupt halt in spending power and a fall in confidence resulting in a transitory increase in savings.

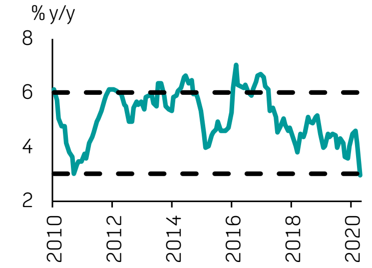
Concerningly, the number of discouraged work-seekers rose by 63 000 (+2.2% q/q), although so too did the labour force participation rate by 0.5 percentage points to 60.3%. This highlights that more individuals entered the labour force in 1Q20, although the majority were likely unsuccessful in securing employment.

It must be noted that according to the QLFS survey, Stats SA deferred face-to-face data collection on 19 March 2020 amid the outbreak of Covid-19. Resultantly, some of the dwellings used in the sampling frame, specifically 2%, were not surveyed. To circumvent this issue, imputations were done where probable.

Overall, conditions in the labour market remain perturbing. According to our latest estimates, the economy could well shed – at a minimum – roughly 868 000 jobs this year as a result of the adverse impact of stringent lockdown restrictions and consequently a weak economic growth outcome. We expect the majority of job shedding to occur in the leisure and hospitality sector, as well as in discretionary retailing, amid stricter enforced regulations for these sectors.

Consumer price inflation slows in April

Figure 6: CPI inflation



Source: EconoStat, Stats SA

The consumer price index (CPI) slowed even further in April, coming in at 3% y/y from 4.1% in March and in line with Bloomberg consensus expectations.

The moderation in the overall inflation profile can largely be ascribed to the transportation subcomponent, which contracted by 3.5% y/y in April after rising 3.4% in the previous month. The R1.88 per litre decline in fuel price in the month was largely responsible for the softer transport inflation print. In addition, more subdued vehicle price inflation (+3% y/y from 4.2% in March) provided some auxiliary support.

Conversely, food inflation continued to normalise, rising to 4.6% y/y in April from 4.4% in March. This was largely driven by higher meat prices which jumped 6.1% y/y from 5% in the previous month as the effects of the supply imbalance from the ban on live animal auctions due to foot-and-mouth disease continues to wane.

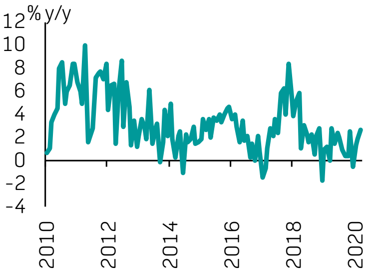
It is worth noting that the April inflation print is based on a limited sample set for the month amid lockdown restrictions preventing data collectors from visiting stores.

A number of methods were used to circumvent data collection issues. These include online collection where possible (accounting for roughly 20% of the total data collection); certain surveyed components for April were kept constant in the index; and imputations were used where plausible.

In the coming months, we expect the strong disinflationary trend to continue which may well result in CPI printing below the lower bound of the SARB's 3% to 6% inflation target. A significant deterioration in the output gap amid stringent lockdown measures, subdued real disposable income and a further deterioration in the labour market are expected to adversely impact on corporates' ability to pass on material price increases. Moreover, relatively low international oil prices should keep transport inflation well contained. These factors potentially allow some scope for the SARB to cut the repo rate even further. For these reasons we have pencilled a further 50bps worth of cuts before the end of the year.

Retail sales climb higher in March

Figure 7: Retail sales



Source: EconoStat, Stats SA

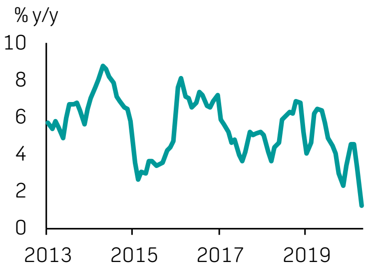
Retail sales climbed to 2.7% y/y in March from 1.9% in the previous month and registers as the highest increase since April 2019.

General dealers, and pharmaceutical goods, cosmetics and toiletries purchases surged 11.6% y/y and 13.9% respectively. The significant spike in these subcomponents can likely be ascribed to panic buying ahead of strict lockdown measures in the month due to the outbreak of Covid-19. Unsurprisingly, clothing and footwear, and household furniture and appliances plunged 14.3% y/y and 10% respectively. The uncertainty surrounding the current operating environment likely resulted in consumers holding back on these discretionary purchases.

Going forward, we expect retails sales to drop precipitously, particularly against the backdrop of lower real disposable income growth, a weak labour market and dwindling consumer confidence. However, we anticipate essential purchases, such as food and beverages, to fare much better in the current downturn, although there may be some substitution for more affordable brands or products.

Producer prices slide further in April

Figure 8: PPI for final manufactured goods



Source: EconoStat, Stats SA

As anticipated, the producer price index (PPI) for final manufactured goods slowed further to 1.2% y/y in April after easing to 3.3% in March and below the Bloomberg consensus expectations of 2%. The April print is the lowest annual growth rate since 2009. On a month-on-month basis PPI fell by 0.7%.

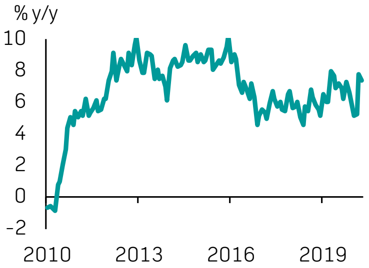
The main contributor to annual producer price inflation was the food products, beverages and tobacco product subcomponent, which increased by 3% y/y and contributed 1 percentage point (ppt) followed by transport equipment (+9.2% y/y and 0.9ppt). Unsurprisingly, due to lower fuel prices, coke, petroleum, chemical, rubber and plastic products was the largest detractor from the monthly reading, retreating by 3.9% m/m and detracting 0.8ppt.

As with the April CPI release, Stats SA noted that due to lockdown restrictions some data points have had to be imputed where plausible. The weight of imputations was naturally higher in April, which accounted for 22.5% of the complete PPI for the final manufactured goods component, when compared to an average of 3.4% for January to March.

Looking ahead, we expect a similar trend for the PPI of final manufactured goods to that of headline CPI, which is to remain subdued in the short term as a result of constrained domestic demand during the lockdown period as well as contained oil prices.

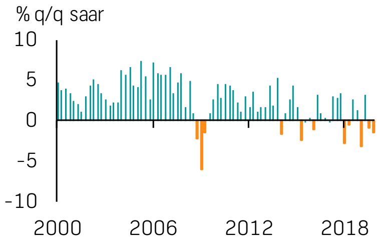
Week ahead

Figure 9: Private sector credit



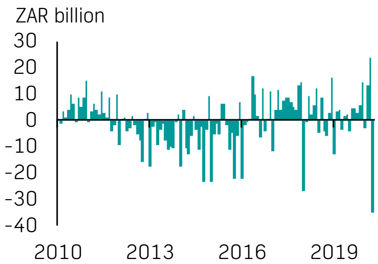
Source: EconoStat, SARB

Figure 10: GDP



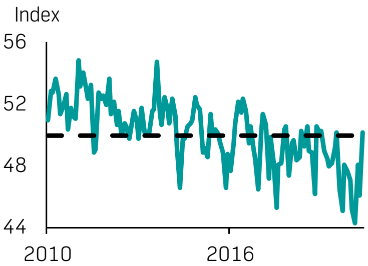
Source: EconoStat, Stats SA

Figure 11: Trade balance



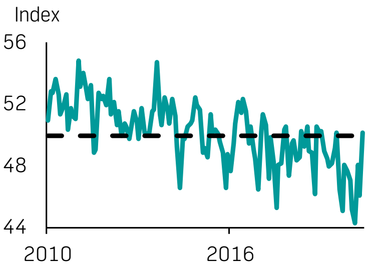
Source: EconoStat, SARS

Figure 12: Absa PMI



Source: Absa, BER, EconoStat

Figure 13: New vehicle sales



Source: EconoStat, Naamsa

A number of first-tier data releases are due out next week, commencing with May private sector credit, first-quarter GDP, as well as the May trade balance due out on Tuesday. The Absa Purchasing Managers' Index (PMI) and new vehicle sales are scheduled for release on Wednesday. The week then closes with first-quarter current account data on Thursday.

Private sector credit most recently slowed to 7.4% y/y in April from 7.7% in the previous month. We have observed a moderation in household credit appetite since December last year and we expect much of the same in the April release. Due to stringent lockdown measures and disruptions at the deeds office, we anticipate mortgage advances – roughly 58% of total household credit – to retreat even further. Conversely, we anticipate corporate credit advances to remain elevated as the need for working capital support amid a period of margin squeeze likely remained evident in May.

Given that March retail sales came in slightly below our expectations, our nowcast model predicts that South Africa likely remained in recession in the first quarter of the year. Accordingly, we anticipate **GDP** growth to have contracted by 2.6% q/q on a seasonally adjusted and annualised basis in the first quarter. The extractive sectors of the economy, i.e. mining and manufacturing, are expected to be among the largest detractors from economic growth in the quarter.

After registering a record trade deficit of R35 billion in April, we anticipate that the **trade balance** likely jumped back into surplus territory. The reopening of mining operations during the month may well have supported export sales, while subdued international oil prices and constrained domestic activity likely contained the import bill.

The direction the **Absa PMI** headline reading will take in the June release is uncertain due to the significant distortion of the supplier delivery subcomponent in the series. While the reading is usually associated with increased activity in the manufacturing sector, the subcomponent continues to strongly suggest that suppliers are less busy amid lacklustre demand conditions. However, we continue to expect marked weakness in new sales orders and business activity subcomponents as the economy struggles to contend with lockdown measures and a weak operating environment.

We expect that **new vehicle sales** continued to contract in June – albeit at a more decelerated pace compared to the 68% y/y contraction in May. The recent easing of lockdown restrictions and reopening of the economy may well have provided some respite. However, we believe it will take some time for the industry to return to normality amid weak consumer confidence, elevated vehicle pricing relative to income levels and weak labour market conditions.

We anticipate a further narrowing in the **current account** deficit (as a percentage of GDP) in the first quarter of the year largely due to a more marked increase in the trade surplus in the quarter compared to the previous quarter.

Tables

The key data in review

Date	Country	Release/Event	Period	Act	Prev
23 Jun	SA	SARB leading indicator (% y/y)	Apr	-8.2	-3.1
	SA	Unemployment (%)	1Q20	30.1	29.1
24 Jun	SA	CPI (% y/y)	Apr	3.0	4.1
	SA	Retail sales (% y/y)	Mar	2.7	1.9
	SA	National Treasury Emergency Budget	Jun	-	-
25 Jun	SA	PPI (% y/y)	Apr	1.2	3.3

Data to watch out for this week

Date	Country	Release/Event	Period	Survey	Prior
30 Jun	SA	Private sector credit (% y/y)	May	-	7.4
	SA	GDP	1Q20	-4.5	-1.4
	SA	Trade balance (ZAR billion)	May	-	-35.0
1 Jul	SA	Absa PMI (Index)	Jun	-	50.2
	SA	New vehicle sales (% y/y)	Jun	-	-68.0
2 Jul	SA	Current account (% of GDP)	1Q20	-	-1.3

Source: Bloomberg ("Survey" is the consensus forecast)

Financial market indicators

Indicator	Close	1 W	1 M	1 Y
All Share	53 914.05	-0.1%	7.7%	-7.6%
USD/ZAR	17.15	-1.9%	-2.8%	19.5%
EUR/ZAR	19.24	-1.7%	0.0%	17.9%
GBP/ZAR	21.29	-1.9%	-1.0%	16.9%
Platinum US$/oz	805.50	-0.4%	-5.2%	-0.6%
Gold US$/oz	1 763.79	2.4%	1.8%	23.9%
Brent US$/barrel	41.05	-1.1%	15.5%	-36.9%
SA 10-year bond yield	7.56	-2.1%	-0.7%	-7.4%

FNB SA Economic Forecast

Economic Indicator	2017	2018	2019	2020f	2021f	2022f
Real GDP % y/y	1.4	0.8	0.2	-8.0	5.5	0.5
Household consumption expenditure % y/y	2.1	1.8	1.0	-7.0	3.2	0.5
Gross fixed capital formation % y/y	1.0	-1.4	-0.9	-31.6	5.0	-0.6
CPI (average) % y/y	5.3	4.6	4.1	3.0	3.7	4.0
CPI (year end) % y/y	4.7	4.5	4.0	2.5	3.9	4.7
Repo rate (year end) % p.a.	6.75	6.75	6.50	3.25	3.25	3.25
Prime (year end) % p.a.	10.25	10.25	10.00	6.75	6.75	6.75
USD/ZAR (average)	13.3	13.3	14.4	16.1	15.5	16.3

Source: FNB

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