THE WEAK ECONOMY PUSHES **SA CLOSER TO A DOWNGRADE**

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ABOUT **THE AUTHOR**

As Sake Economist of the Year, Rian's insight into and forecasts of how macroeconomic developments impact financial markets inform our top-down views.

KEY TAKEOUTS:

- THE ECONOMY FAILS THE UNEMPLOYED
- REVENUE FALLS WAY SHORT OF TARGET
- GROWING DEFICIT SPELLS TAX HIKES AND DOWNGRADES
- PRESSURES ON THE RAND AND ECONOMY MOUNT

While August was a generally good month for South Africa, characterised by a firming rand and an unexpectedly strong second quarter GDP report, the tide turned quite dramatically in September as concerns over the economy, labour market, the fiscal situation and ratings mounted anew.

SLOW GROWTH AND LOOMING TAX HIKES

On the real economy front (the part of the economy dealing with producing goods and services), early data for the third quarter points to a renewed slowdown after the surprise 2.5% annualised expansion in GDP in the second quarter. While the news was not universally bad, the renewed slowdown highlights the fact that the economy still faces considerable cyclical and structural headwinds –with more tax hikes looming, too, as the fiscal situation remains precarious. While we have kept our full-year GDP forecast of 0.8% unchanged, it is difficult to see any meaningful improvement anytime soon.

UNEMPLOYMENT SOARS AND FOREIGNERS EXIT

The consequence of the slow-growing economy is that it is unable to cope with the growing labour force, reflected in the fact that in the year to June only about half of the 1.1 million people that joined the labour force actually managed to find some kind of a job. This resulted in the unemployment rate rising by a full one percentage point to a record 27.7% in the second quarter. Another implication of low growth is that we are falling off global investors' radar screens. This is starkly highlighted in the heavy selling by foreigners of local listed equities since last year. After selling R125 billion of equities in 2016, so far this year selling totals R91 billion. This compares poorly with the R66 billion of sales in 2008 at a time when emerging markets, in general, suffered heavy selling as the global financial crisis erupted.

BUDGET DEFICIT TARGET AT RISK

Data released during September highlighted how precarious the fiscal situation is, owing to the weak economy. Over the first five months of the 2017/18 fiscal year, tax revenues rose by only 3% against a budget target of 9% – an undershoot against budget of about R20 billion for this period alone. It is difficult to see this situation improving sufficiently over the remainder of the fiscal year in order to meet the fiscal targets. In fact, concerns are that it may deteriorate further as corporate profits remain under pressure, subdued imports are depressing VAT on imported goods and wage settlements are decelerating, causing under-recoveries against budget on personal income taxes. It therefore seems that the budget deficit target for the full fiscal year of 3.1% of GDP could be missed by a wide margin of 0.5% of GDP, or even more. Such an outcome will not only pressure National Treasury to raise taxes considerably, piling more pressure on the economy, but also increases the risk of more downgrades to our ratings, with the investment grade on local government bonds particularly at risk.

With concerns mounting over the economy and ratings, and foreigners selling their locally held shares, the rand weakened notably from around R13.00 to the US dollar at the end of August to R13.60/US$ by the end of September. The weakening rand prompted the South African Reserve Bank to, against expectations of a cut, keep the repo rate unchanged at its mid-month meeting.

With the economy, the fiscal situation, consumers and businesses all under considerable pressure, the next few months will be difficult and can potentially see more pressure on the rand as three key events will take place in the final quarter of the year – namely, the Medium Term Budget late in October, ratings reviews by Moody's and S&P late in November, and the ANC's elective conference in December.

One can only hope that 2018 will bring less political uncertainty, faster progress on confidence- and growth-enhancing economic policy reforms and a faster cyclical economic recovery. If not, the pressures on the rand and the economy will not ease.

Data sourced from StatsSA, JSE, National Treasury