Sanlam

Economic Overview for Business Owners

July 2017

Inadequate fiscal tax consolidation amidst weaker growth prospects

Ordinarily, the bounce in terms of trade, slowing inflation which portends a peak in the interest rate cycle, an apparent trough in corporate profits growth, sound global growth and an end to drought would be supportive of a firm upswing in domestic economic growth.

However, the cautiously optimistic view for the South African economy in 2017, informed by the developments above, has begun to unravel. Some bright spots remain, notably downside inflation surprises and continued optimism as regards agriculture production (especially maize).

Indeed, real household spending may yet receive a boost from lower inflation, but available information suggests the shock to business confidence (amplified by the removal of Pravin Gordhan as Minister of Finance in late March 2017) amidst continued sovereign debt rating downgrades, is likely to weigh heavily on fixed investment prospects.

Not only is there a clear correlation between business confidence and private sector fixed investment, but the marginal rate of return on fixed investment spending is too low to initiate an upturn in this expenditure category. For example, in the manufacturing sector the Bureau for Economic Research's second quarter business survey shows that manufacturers expect to *reduce* their fixed investment expenditure over the next twelve months. This is disconcerting considering the erosion of productive capacity in manufacturing, as reflected in the declining level of the real capital stock in this sector relative to gross domestic product (GDP) in recent years.

A lack of appetite for investment (and hence employment growth) is the key risk to the economic outlook and appears set to constrain the overall level of real GDP growth to below 1% in 2017, with limited prospects for an improvement in 2018.

Whereas it is hoped that the Reserve Bank will respond to slowing inflation and the palpably weak state of domestic demand by cutting its policy rate, the Bank's communication suggests it will proceed cautiously, not least because of its concern for the currency. Over the past twelve months the rand has been well supported as foreign investors bought South Africa's relatively high yield domestic currency bonds amidst increased global risk appetite. However, although persistently modest inflation outcomes in developed economies give pause for thought, there is an argument that the expansion of the aggregate G4 central banks' balance sheets could draw to a close by 2018, before possibly shrinking as from 2019. This would imply a sea change in developing markets' (DM) monetary policy, which portends tightening of global financial conditions – at the very least a warning signal for emerging market (EM) countries relying on foreign capital inflows.

In addition, the Bank's medium term inflation forecast also remains relatively sticky and inflation expectations are elevated.

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Arguably, too, amidst expectations of further sovereign debt rating downgrades, fiscal policy is no longer as supportive of the inflation targeting objective as it was a few years ago.

On balance, while likely downside surprises in inflation in the near term should still prompt the Bank to cut its repo rate before year-end, the monetary authorities do not appear to have any leeway to cut interest rates aggressively in an attempt to bolster economic growth.

One of the more important implications of these developments is the impact on the fiscal outlook. In my opinion, Standard and Poor has rated South Africa's foreign currency denominated debt fairly at BB+, considering quantitative factors such as per capita income, the debt level and South Africa's external accounts. However, the agency is concerned that the economy may not grow as expected, while political and policy uncertainty heightens this risk – hence, the negative outlook on the rating.

A concern is that, even if South Africa stabilises its debt level over the medium term, this would not guarantee long-term fiscal sustainability. The government's interest bill is currently still manageable, given the large portion of debt issued previously at lower interest rates, while the maturity structure of debt has lengthened. But, at close to three per cent the current real interest rate on new long-term government debt issues is too high. Given this real interest rate and potential real GDP growth of just 1.5% this implies that fiscal policy, in time, is likely to be unsustainable in the absence of a further improvement in the primary budget surplus to around 1% of GDP. But meeting a primary balance surplus of this magnitude would be difficult considering growing demands on expenditure, including the expected shift towards national health insurance. In this regard, next year's public sector wage increase (35% of total consolidated expenditure) is likely to prove decisive.

Meanwhile, central government guarantee exposure to state-owned companies (SOC) debt is expected to continue increasing. If it climbs to R478 billion (the total level of guarantees already extended) from R308 billion at the end March 2017, it would amount to 10% of GDP. In addition, other contingent liabilities, including the Road Accident Fund and claims against government departments amount to R330 billion (7.6% of current GDP).

Central government net worth (measured as debt less fixed capital stock) has deteriorated markedly since the global financial crisis. Admittedly, net worth is difficult to measure – especially the asset component, which should be as broad as possible. However, the present value of future tax revenue, for example, is not readily quantifiable. But, assuming fixed capital stock is a reasonable proxy for assets, it can be shown that the central government's balance sheet has deteriorated in recent years, through a combination of rising liabilities and a lower asset base.

Overall, the fiscal consolidation path is not optimal. The central government has not protected its balance sheet. Also, it has not cut consumption spending in favour of stronger capital expenditure. Ultimately, the risk South Africa faces in the absence of firmer economic growth is continued sovereign debt rating downgrades over time, persistent currency weakness and, eventually, upward pressure on interest rates.

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