Deloitte.

Economic Insights – South Africa

Recession: what this means and what lies ahead

9 June 2017

Internal use only

Recessionary territory

"South Africa is now the worst performing major emerging market economy".

- Dr Ira Kalish, Deloitte Chief Global Economist

An economy stuck in low-gear

South Africa has entered a technical recession – defined as two consecutive quarter-on-quarter (q-o-q) contractions. Specifically, the economy shrank by a seasonally-adjusted, annualised rate (SAAR) of 0.7% q-o-q in the first quarter of 2017. Confirming the recession, this follows a contraction of 0.3% q-o-q in Q4 2016.[1]

On top of the second technical recession since 2009, the latest numbers show that the South African economy contracted during four of the last eight quarters.

That said, the latest technical recession came as somewhat of a surprise, with surveys conducted by *Reuters* and *Bloomberg* showing economist expectations of positive growth in Q1. Of further concern is that the poor numbers are for the period preceding the cabinet reshuffle and sovereign debt rating downgrades, which are widely expected to place additional pressure on the South African economy.

Sector performance

Positive performers

Looking at the most recent quarterly performance, only two sectors (agriculture and mining) made a positive contribution to real GDP growth during the first three months of 2017.

Agriculture – emerging from the worst drought on record, the agricultural sector posted an exceptionally strong 22.2% q-o-q expansion. However, there is a considerable amount of base effects buried in this growth, given that the sector contracted during the preceding eight quarters.

Nevertheless, the recovery of the agricultural sector is one of the primary factors driving forecasts of positive growth in 2017.

Mining & quarrying – with production increasing by 3.5% q-o-q during the quarter under review, analysts had been expecting a positive contribution from the sector to real GDP growth in Q1.

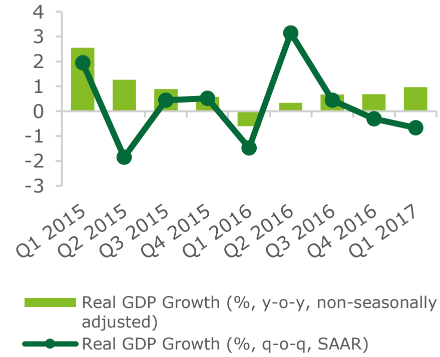
Similar to the agricultural sector, base effects from a sharp contraction of 11.5% q-o-q in the previous quarter helped the mining sector post an impressive 12.8% q-o-q in Q1 2017. Going forward, the mining sector is expected to be the other (on top of the agricultural sector) key driver of South Africa's economic expansion in 2017.

Growth 'draggers'

There were negative contributions in Q1 2017 from all sectors other than agriculture and mining.

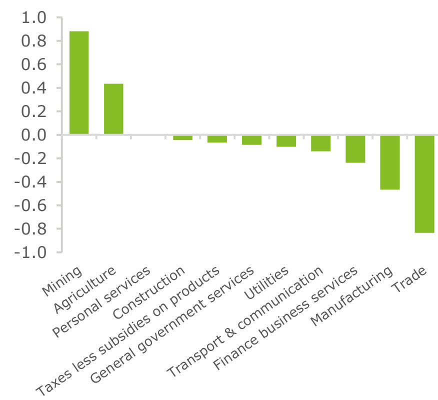
Trade, catering & accommodation – making the largest negative contribution (-0.8 percentage points) to Q1 2017 real GDP growth, the trade sector's sharp 5.9% q-o-q contraction was not wholly unexpected, given that retail sales decreased by 1.1% q-o-q in the first quarter.

Figure 1. Real GDP growth (%), Q1 2015 – Q1 2017



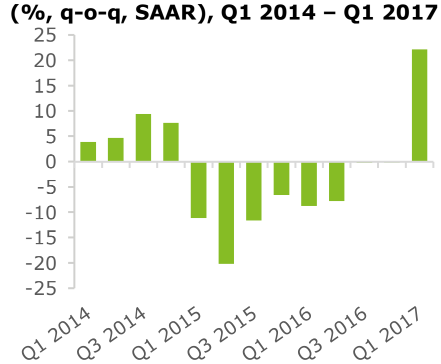
Source: StatsSA, 2017

Figure 2. Contribution to real GDP growth (%), Q1 2017



Source: StatsSA, 2017

Figure 3. Agricultural sector growth (%, q-o-q, SAAR), Q1 2014 – Q1 2017



Source: StatsSA, 2017

[1] Gross domestic product – first quarter 2017, Statistics South Africa (StatsSA), 2017

Manufacturing – going into the Q1 2017 GDP release, the manufacturing sector was expected to be one of the major 'draggers' on economic growth during the period. The sector has been under considerable pressure over the last few years, contracting in five of the last eight quarters.

More recently, manufacturing production fell during all three months of the first quarter of 2017, thereby decreasing by 0.9% in Q1 2017 compared to Q4 2016.

Looking at some of the other remaining sectors, the ***transport, storage & communication*** sector contracted by 1.6% q-o-q in the first quarter of 2017, seeing an end to three consecutive quarters of positive growth. In turn, the ***construction*** sector contracted by 1.3% q-o-q, although the contribution to the overall real GDP growth rate from the construction sector was negligible (-0.05 percentage points).

The ***finance, real estate & business*** services sector also posted a negative contribution to real GDP growth in Q1 2017, marking the first quarter of negative growth since the second quarter of 2009. At the time, the sector was reeling from negative fallout in the wake of the global financial crisis.

Downside risks to the outlook for 2017

Looking ahead, the outlook for real GDP growth for the rest of the year is not overly optimistic. Still, the majority of forecasters expect an uptick from the lacklustre 0.3% growth seen last year. The World Bank recently reduced its forecast for South Africa's real GDP growth by half a percentage point to only 0.6% in 2017. Notably, the forecast update preceded the Q1 2017 GDP release, which is likely to place downward pressure on future forecast updates.

On the more optimistic side, the National Treasury expects 1.3% growth this year, while the International Monetary Fund (IMF) and the South African Reserve Bank (SARB) both see the economy expanding by 1% in 2017. However, these forecasts also predate the latest numbers, and will likely also be revised downwards.

Even with the already-tepid real GDP projections, there are several downside risks that could further adversely affect economic expansion this year. External risks, including uncertainty pertaining to US (particularly fiscal) policies, the economic rebalancing in China, and the ongoing process of the UK leaving the EU (popularly known as Brexit), arguably are negligible compared to the downside risks stemming from the domestic arena.

Domestic risks

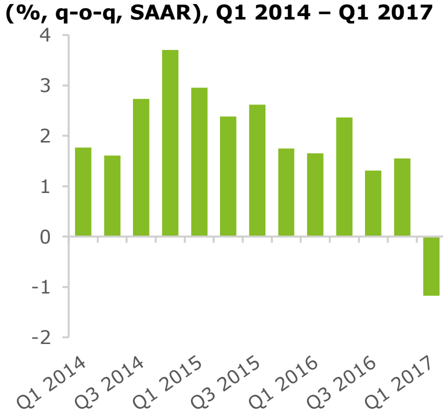
Local currency downgrades – in its latest *Financial Stability Report*, the SARB noted its concern about the possibility of more downgrades, particularly another local currency downgrade to sub-investment grade.

Currently, only Fitch Ratings has South Africa's local currency debt on so-called 'junk status'. The SARB stated that a local currency downgrade to sub-investment grade by another credit rating agency would mean exclusion from several major global bond indices (the Fitch downgrade already means exclusion from certain JPMorgan emerging market bond indices). The possibility of further exclusions is *"disconcerting given the country's dependency on portfolio inflows to finance its current account deficit"*.

Political volatility – the uptick in political uncertainty, particularly the cabinet reshuffle at the end of March 2017, led directly to South Africa's rating downgrades. Looking ahead, international rating agencies have noted that further increases in political uncertainties and volatility could lead to additional downgrades.

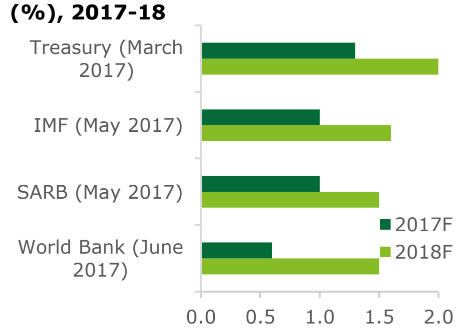
S&P noted in its rating affirmation statement on 2 June 2017 that political risks are set to *"remain elevated this year"*. On top of downward rating pressure, these elevated risks could potentially contribute to a lack of policy continuity, slower fiscal consolidation, and further deterioration in investor confidence.

Figure 4. Financial sector growth (%, q-o-q, SAAR), Q1 2014 – Q1 2017



Sources: StatsSA, 2017

Figure 5. Real GDP growth forecasts (%), 2017-18



Sources: Various, 2017

Contacts

Dr Martyn Davies
Managing Director: Emerging Markets & Africa, Deloitte Africa
mdavies@deloitte.com
+27 (0)11 209 8290

Hannah Edinger
Associate Director: Africa Services Group, Deloitte Africa
hedinger@deloitte.com
+27 (0)11 304 5463

Hanns Spangenberg
Senior Economist: Africa Services Group, Deloitte Africa
hspangenberg@deloitte.co.za
+27 (0)11 209 8058