

Economic Commentary

SARB Quarterly Bulletin (Q2 2010)

Domestic expenditure rose at slower pace, while current account deficit narrowed by more than expected

- Gross domestic expenditure growth eased sharply as household consumption expenditure expanded at a slower, but still impressive, rate.
- The household debt to income ratio and debt service cost to disposable income ratio dropped, as disposable incomes outpaced credit creation.
- Household spending is likely to remain weak during the second half of the year, constrained by weak job market prospects and still high levels of household debt.
- The current account deficit narrowed to 2,5% of gdp, its lowest level since the first quarter of 2004, helped by a trade surplus, higher travel receipts and lower dividend payments. A deficit of 3,4% is now expected for 2010 as a whole after last year's 4%.
- The economic recovery is likely to remain weak during the remainder of this year, with a growth rate of around 3% for the year as a whole, while the current account deficit will probably widen in the second half of 2010.
- We believe there is still downside risk to interest rates, although a further cut would require negative growth surprises both globally and locally, given that inflation is now close to its lows in this cycle.

Expenditure

Table 1 : Expenditure breakdown of gdp, Q-o-q SAAR (%)

Spending category	2007	Q2'08	Q3'08	Q4'08	2008	Q1'09	Q2'09	Q3'09	Q4'09	2009	Q1'10	Q2'10
Household consumption expenditure	5.5	0.6	-1.5	-2.2	2.4	-5.8	-5.2	-1.9	1.6	-3.1	5.7	4.8
Government consumption expenditure	4.7	-2.3	10.1	3.5	4.9	6.7	0.8	8.2	2.1	4.7	7.3	7.2
Fixed capital formation	14.2	7.9	12.4	2.8	11.7	5.2	-2.5	-6.5	-0.9	2.3	0.2	0.8
Change in inventories (R'bn)	19.8	-6.5	-7.6	-26.4	-7.7	-6.8	-48.5	-56.9	-38.4	-37.6	-8.7	-7.2
Gross domestic expenditure (gde)	6.4	-2.5	0.7	-2.7	3.3	3.3	-10.8	-1.6	4.9	-1.8	12.1	2.3
Exports	5.9	45.9	5.1	-17.2	2.4	-56.9	-12.6	11.0	20.0	-19.5	-15.3	18.0
Imports	9.0	7.4	2.5	-21.1	1.4	-28.7	-36.2	-1.0	26.2	-17.4	14.2	11.4
Net exports (R'bn)	-59.2	-66.0	-63.1	-53.4	-68.9	-103.3	-62.8	-51.4	-59.7	-20.6	-93.0	-89.5
Gross domestic product (gdp)	5.5	5.5	1.3	-0.7	3.7	-7.4	-2.8	0.9	3.2	-1.8	4.6	3.2

Source: SARB

Comment:

Growth in gross domestic expenditure eased sharply during the second quarter, reflecting slower growth in household expenditure and a slower rate of change in inventory depletion. Government spending remained buoyant, boosted by the purchase of four military aircraft. Fixed capital formation increased marginally, helped by some rise in private sector and public corporation spending, which offset a decline in investment by government.

Household consumption expenditure growth slowed, but remained impressive during the second quarter following a strong rebound in the first quarter. The performance of major components was mixed. Spending on durable goods accelerated by a seasonally adjusted and annualised 37,8% over the quarter, its strongest growth rate since the second quarter of 1987, with lower interest rates and improved access to credit boosting purchases of big ticket items such as vehicles as well as furniture and other household appliances.

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Semi-durable goods such as clothing also performed well, growing by 10,6% off a high base. Spending on non-durable goods also rose strongly, helped by the FIFA World Cup, which enhanced spending on goods such as fuel and power as well as medical services and pharmaceutical products. In contrast, spending on services contracted by 7,7%. This was attributed to weak spending by South Africans on travel and accommodation during the World Cup relative to increased spending by foreigners.

Table 2 : Consumer spending trends, Q-o-q SAAR (%)

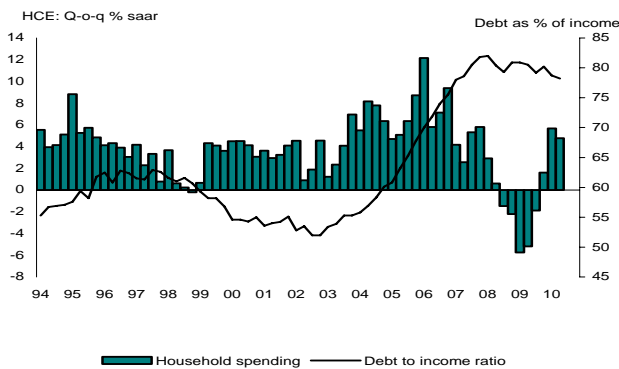
Spending category	2007	Q2'08	Q3'08	Q4'08	2008	Q1'09	Q2'09	Q3'09	Q4'09	2009	Q1'10	Q2'10
Durable goods	1.9	-20.0	-13.2	-18.9	-7.1	-8.4	-17.6	0.7	15.2	-11.3	16.8	37.8
Semi-durable goods	11.3	3.9	0.0	-0.9	4.2	1.3	-4.8	-7.2	-0.6	-1.5	28.4	10.6
Non-durable goods	5.0	0.7	-2.2	-3.2	1.5	-9.9	-1.7	-5.4	-0.7	-4.4	9.5	10.9
Services	5.5	5.4	1.6	2.3	5.1	-3.4	-5.4	2.0	1.6	-0.6	-4.6	-7.7
Total	5.5	0.6	-1.5	-2.2	2.4	-5.8	-5.2	-1.9	1.6	-3.1	5.7	4.8

Source: SARB

Expenditure by general government remained firm, increasing by seasonally adjusted and annualised 7,2% q-o-q following 7,3% growth in the first quarter. However, this was mainly boosted by the purchase of four military aircraft, while high spending on salaries and wages of government officials and on goods and services related to the hosting of the World Cup also contributed.

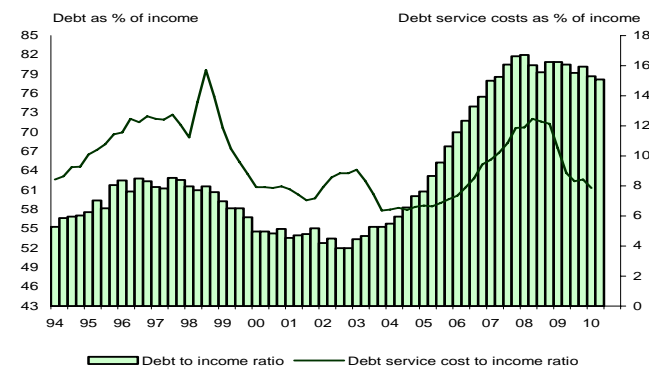
Weak credit conditions helped the **household debt to disposable income ratio** to edge down to 78,2% during the second quarter from 78,7% during the previous quarter, while the debt service cost to disposable income edged down to 8,0% from 8,2%.

Chart 1 : Growth in household income versus household debt levels



Source: SARB

Chart 2 : Household debt and debt service cost to personal income



Source: SARB

Fixed capital formation increased marginally by a seasonally adjusted and annualised 0,8% q-o-q following a 0,2% q-o-q increase in the first quarter. Over the second quarter, fixed investment activity was contained mainly by weak investment by **general government**, where there have been persistent declines since the first quarter of last year. Government capital expenditure fell by seasonally adjusted and annualised 7,2% during the second quarter following an 8% drop in the first quarter, reflecting reduced capital outlays by all levels of government. However, capital expenditure by the **private sector** turned the corner, growing by seasonally adjusted and annualised 0,4% following sharp declines throughout 2009 and early part of this year, suggesting that confidence is starting to improve as worries about the economy abate. Capital formation by the manufacturing and mining sectors, in particular, rose strongly by seasonally adjusted and annualised 6,8% q-o-q and 3,1% q-o-q respectively following sharp declines in 2009. Capital formation by **public corporations** remained firm (up by 6,5% q-o-q), although the growth rate moderated from 7,4% q-o-q in the first quarter, mainly supported by Transnet's multiproduct petroleum pipeline project from Durban to Gauteng as well as some freeway upgrade and expansion projects.

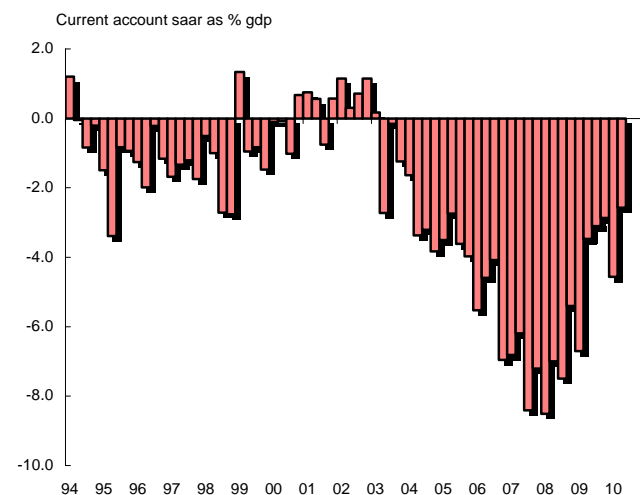
Table 3 : Trends in capital formation by sector: Q-o-q SAAR (%)

Sector/Institution	2007	Q2'08	Q3'08	Q4'08	2008	Q1'09	Q2'09	Q3'09	Q4'09	2009	Q1'10	Q2'10
Mining & quarrying	29.8	27.0	25.1	31.7	13.2	3.6	-12.9	-28.4	-12.7	2.7	-5.0	3.1
Manufacturing	7.7	7.4	15.1	-8.4	8.2	-43.9	-17.2	-32.9	-18.8	-20.9	-7.2	6.8
Power & water	34.2	2.0	58.9	43.3	41.9	187.2	101.7	6.4	1.9	69.9	4.8	-2.0
Transport & communication	15.2	12.9	13.5	1.8	31.3	56.5	-20.2	11.0	21.2	12.9	8.5	5.9
Finance & real estate	6.7	6.0	-17.6	-11.6	-8.2	-9.7	-4.3	8.3	-8.8	-7.1	5.3	1.8
Community services	19.6	-5.9	20.4	-1.1	9.0	-14.9	-4.9	-4.8	8.4	-3.3	-12.9	-11.8
Total	14.2	7.9	12.4	2.8	11.7	5.2	-2.5	-6.5	-0.9	2.3	0.2	0.8
General Government	19.6	7.9	10.0	3.4	13.4	-3.2	-6.2	-6.9	-10.0	-1.2	-8.0	-7.2
Public corporations	33.9	17.3	46.1	-2.1	41.0	147.9	21.7	17.0	8.7	40.7	7.4	6.5
Private Sector	9.8	5.6	5.3	4.0	5.6	-18.1	-9.5	-14.5	-2.3	-7.0	-0.7	0.4

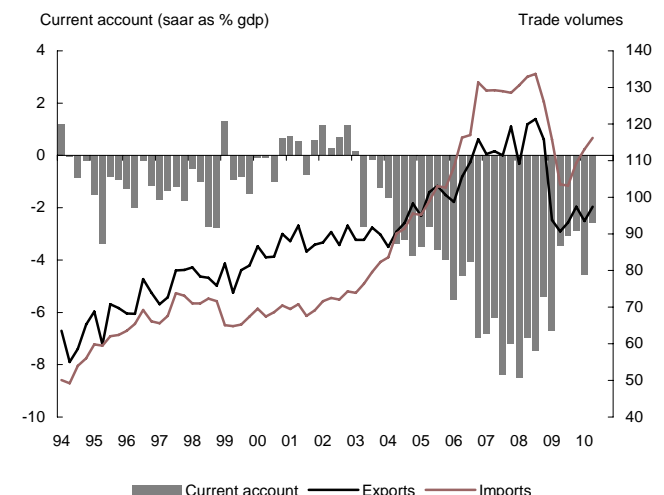
Source: SARB

The rate of decline in **real inventory investment** eased further to R7,2 billion during the second quarter from R8,7 billion in the first quarter, mainly due to a slower rundown of inventories in the manufacturing, trade and transport sectors in line with improved economic conditions.

Balance of payments – current account

Chart 3 : Balance on the current account

Source: SARB

Chart 4 : Current account and change in trade volumes

Source: SARB

Comment

The **current account deficit** narrowed to its lowest level since the first quarter of 2004, helped by a swing back into surplus on the trade account, higher travel receipts and lower dividend payments. The current account deficit dropped to a seasonally adjusted and annualised R66,9 billion in the second quarter from R116,1 billion in the previous quarter, equivalent to 2,5% of gdp from 4,6%.

The **trade account** recorded a surplus of R13,2 billion following a R12,9 billion deficit in the first quarter as exports rose faster than imports. Export values benefitted from the strong rise in international commodity prices, particularly in precious metal prices, while import values were contained by the firmer rand and low global inflation.

Merchandise exports rose to a seasonally adjusted and annualised R552,0 billion from R518,6 billion, up by 6,4%. Export volumes increased by 1,0%, as the volume of mining exports rose by 5,0%, while that of manufactured exports increased by 0,5%. The rand price of exports increased by 5,5% during the quarter. Net gold exports rose by 19,3% to R59,0 billion from R49,5 billion, benefitting from the higher international gold price as well as higher export volumes.

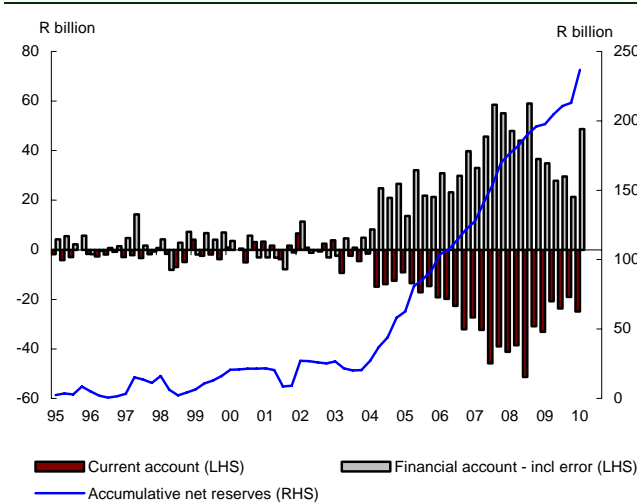
Merchandise imports increased at a slower pace, up by only 2,9% to R597,8 billion from R581,0 billion. Import volumes increased by 3,1%, mainly on the back of the purchase of four military aircraft, while the rand price of merchandise imports fell by 0,2% during the quarter, reflecting mainly the strong rand and subdued global inflation.

The **terms of trade** (the ratio of export to import prices) improved by 5,1% after rising by 0,6% in the first quarter.

The deficit in the **net service, income and current transfer account** narrowed significantly during the second quarter, boosted mainly by travel receipts related to the hosting of the 2010 FIFA World Cup and lower dividend payments. The deficit eased to R80,1 billion from R103,2 billion in the previous quarter, equivalent to 3,0% of gdp, its lowest level since the third quarter of 2005. The Reserve Bank estimated that total spending by foreigners amounted to R15 billion in the second quarter, with about R3,5 billion of that attributable to spectators attending the 2010 FIFA World Cup. Travel receipts reached 51% of total receipts for services, income and current transfers in the second quarter compared with an annual average of 42% in the preceding decade.

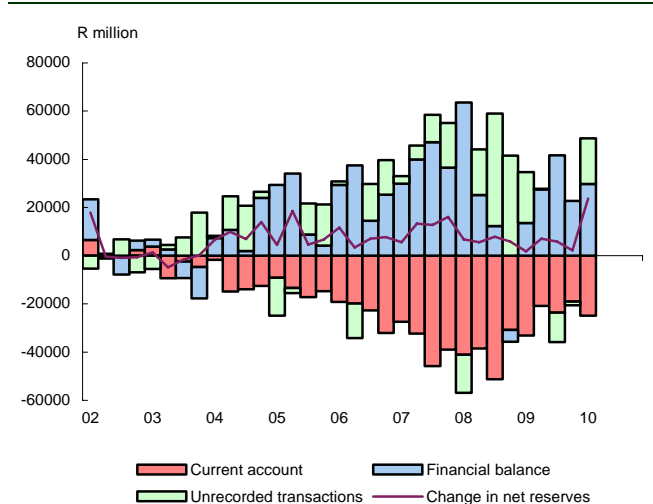
Balance of payments – financial account

Chart 5 : Balance of payments and net reserves



Source: SARB

Chart 6 : Breakdown of financial account



Source: SARB

The **financial account** remained in surplus due to strong portfolio inflows as foreign investors continued to inject funds into emerging economies, particularly commodity exporters. Inflows (including unrecorded transactions) amounted to R21,8 billion from R48,6 billion in the previous quarter. The financial account surplus fell to 3,3% of gdp from 7,8% in the first quarter.

Net portfolio inflows remained strong at R25,5 billion during the quarter, with foreign investors pumping a net R28,4 billion into local markets during the quarter, although this was down from the R44,1 billion recorded in the first quarter. Net foreign portfolio inflows amounted to R179,6 billion in the first half of 2009, made up of R98,9 billion and R80,7 billion of net equity and bond purchases, respectively. Domestic investors sent only R2,9 billion to offshore markets in the second quarter, down from R5,5 billion in the first quarter.

Net direct investment outflows amounted to R2,5 billion, following net inflows of R4,6 billion in the first quarter. Inward investment by foreigners was R1,7 billion from R3,7 billion in the previous quarter, while South African residents invested R4,2 billion in other countries.

Net other investment inflows amounted to R8,6 billion in the second quarter from a R13,4 billion outflows in the previous quarter as foreign investors pulled R1,5 billion from the local economy, mainly in the form of deposits in local banks, while domestic investors repatriated R10,1 billion from other economies.

Outlook

Consumer confidence should improve during the second half of the year, supported by marginally better employment prospects. Higher wage settlements reached during the negotiation season together with lower interest rates will also improve consumer finances. However, high debt and tight credit conditions will contain the growth in consumer spending. We expect consumer spending to increase by an average 2,5% this year as a whole, following a 3,1% contraction in 2009.

Government consumption expenditure is likely to grow more modestly as the government attempts to reign in the budget deficit to more modest levels over the next three years. Government spending on key basic social services set out in the budget should continue.

Table 4 : Facts and forecasts of key variables

	2006	2007	2008	2009	2010	2011	2012
Growth (real, % change)							
Gdp	5.6	5.5	3.7	-1.8	2.8	3.0	4.2
Gde	8.6	6.4	3.3	-1.8	3.9	4.1	4.8
Pce	8.3	5.5	2.4	-3.1	2.4	3.3	4.5
Gdfi	12.1	14.2	11.7	2.3	-1.5	3.5	5.2
Exports	7.5	5.9	2.4	-19.5	4.0	4.2	7.0
Imports	18.3	9.0	1.4	-17.4	8.1	8.0	8.7
Balance of payments (Rbn)							
Exports	447.7	533.8	704.3	556.4	627.1	758.4	955.2
Imports	477.0	574.3	739.9	554.2	619.6	750.4	937.8
Trade balance	-29.3	-40.5	-35.6	2.3	7.5	8.0	17.5
Net services	-64.5	-104.0	-126.1	-98.8	-96.2	-120.0	-150.8
Current account	-93.8	-144.6	-161.7	-96.6	-88.7	-112.0	-133.4
Capital account	123.6	192.4	187.7	113.6	135.0	181.0	165.0
Change net reserves	29.8	47.8	26.1	17.0	46.3	69.0	31.6
Gross reserves (eop)	178.3	224.3	317.3	267.7	309.0	400.2	460.3
Current account as a % of gdp	-5.3	-7.2	-7.1	-4.0	-3.4	-3.9	-4.2
Gold price (average per ounce)							
\$	605.1	696.5	872.2	973.1	1,201.8	1,303.1	1,352.6
Rand	4103	4919	7208	8217	8884	9739	10759
Exchange rates							
\$/Rand	6.78	7.06	8.26	8.44	7.39	7.47	7.95
Euro-\$	1.26	1.37	1.46	1.39	1.32	1.31	1.25
\$/Yen	116.3	117.7	103.4	93.5	88.6	86.5	88.2
GBP-\$	1.84	2.00	1.83	1.56	1.54	1.54	1.47
Euro-Rand	8.51	9.67	12.10	11.75	9.79	9.77	9.93
Rand-Yen	17.2	16.7	12.5	11.1	12.0	11.6	11.1
GBP-Rand	12.48	14.13	15.16	13.17	11.41	11.47	11.71
Interest rates (end of period)							
Three-month JIBAR	9.18	11.25	11.43	7.23	6.13	6.23	8.78
Prime	12.50	14.50	15.00	10.50	9.50	9.50	12.00
Long bond	7.76	8.35	7.33	9.08	7.57	7.80	8.08
Inflation (average)							
CPI new				7.1	4.4	4.9	6.5
CPIX (metro and other urban)	4.6	6.5	11.3				

Source: Nedbank Economic Unit

Fixed capital formation is likely to remain weak, as some organisations are still reluctant to resume capital spending, while others are sitting on ample spare capacity. We forecast overall gross fixed capital formation to decline by 1,5% this year before picking up slowly in 2011.

Exports fared better during the second quarter despite the global economic recovery losing some momentum. However, export growth will be modest in the remainder of the year as global growth falters. Much will depend on how developed economies fare, particularly those in Europe, which

absorb 35% of South Africa's exports. Developments in the major developing economies like China and India will also be crucial, especially for mineral exports, which account for just over 20% of total exports.

Import growth will be helped by stronger domestic demand on the back of lower interest rates, subdued inflation and improving incomes. The strong rand, if sustained, is likely to boost demand for imports.

Some widening of the current account deficit can be expected in the second half as the trade balance deteriorates, dividend payments pick up and the boost to the services account from the World Cup is removed. However, the deficit will narrow to around 3,4% of gdp in 2010 as a whole compared with 4% in 2009.

Implications

Domestic demand lost some momentum during the second quarter, while export performance improved on the back of better global conditions. Domestic demand growth is likely to be constrained by the weak jobs market, while the uncertain global recovery suggests that the boost from exports is likely to be limited.

Against this backdrop, we believe there is still downside risk to interest rates, although a further cut would require negative growth surprises both globally and locally, given that inflation is now close to its lows in this cycle.

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