

Nedbank

Economic commentary

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SARB QUARTERLY BULLETIN

Domestic expenditure increased sharply and the current account deficit widened by more than expected.

- Gross domestic expenditure rose strongly in the first quarter of the year, mainly reflecting stronger consumer and government expenditure.
- Household demand should remain firm in the months ahead on better employment prospects, income growth, low interest rates as well as the boost from the FIFA World Cup.
- The household debt to disposable income ratio eased, helped by lower interest rates and income growth.
- The current account deficit widened, mainly due to a larger trade deficit.
- The SARB expects the current account deficit to widen to 4,9% of gdp in 2010 from the 4,0% deficit in 2009.
- These figures do not alter our view that interest rates will remain unchanged until well into 2011. However, a negative growth surprise combined with a favourable inflation outlook could still tilt the environment in favour of another cut in this cycle.

Expenditure breakdown of gdp (Q1 2010):

(Q-o-q seasonally adjusted annualised rates)

	2007	Q1'08	Q2'08	Q3'08	Q4'08	2008	Q1'09	Q2'09	Q3'09	Q4'09	2009	Q1'10
Household consumption expenditure	5.5	2.9	0.6	-1.5	-2.2	2.4	-5.8	-5.2	-1.9	1.6	-3.1	5.7
Government consumption expenditure	4.7	11.6	-2.3	10.1	3.5	4.9	6.7	0.8	8.2	2.1	4.7	7.3
Fixed capital formation	14.2	17.5	7.9	12.4	2.8	11.7	5.2	-2.5	-6.5	-0.9	2.3	0.2
Change in inventories (R'bn)	19.8	9.9	-6.5	-7.6	-26.4	-7.7	-6.8	-48.5	-56.9	-38.4	-37.6	-8.7
Gross domestic expenditure (gde)	6.4	14.7	-2.5	0.7	-2.7	3.3	3.3	-10.8	-1.6	4.9	-1.8	12.1
Exports	5.9	-30.2	45.9	5.1	-17.2	2.4	-56.9	-12.6	11.0	20.0	-19.5	-15.3
Imports	9.0	6.5	7.4	2.5	-21.1	1.4	-28.7	-36.2	-1.0	26.2	-17.4	14.2
Net exports (R'bn)	-59.2	-102.2	-66.0	-63.1	-53.4	-68.9	-103.3	-62.8	-51.4	-59.7	-20.6	-93.0
Gross domestic product (gdp)	5.5	2.5	5.5	1.3	-0.7	3.7	-7.4	-2.8	0.9	3.2	-1.8	4.6

Comment:

Gross domestic expenditure increased sharply in the first quarter of this year, with the three major components recording growth. Strong contributions came from household and government sectors, with consumer spending mainly boosted by increased purchases of durable- and semi-durable goods, while government spending was boosted by the purchase of two military aircrafts.

Household consumption expenditure gathered momentum in the first quarter after returning to positive territory in the final quarter of 2009. The strongest growth rate in consumer spending since the last quarter of 2007 could be attributed to a combination of low interest rates, easing inflation, income and wealth growth as well as improved consumer confidence. The breakdown shows that all the components of consumer spending, except services, recorded growth over the quarter. Purchases of durable goods accelerated by over 16% q-o-q, while purchases of semi-durable goods surprised on the upside, surging by a seasonally adjusted and annualised 28,4% q-o-q following three successive quarters of decline. Non-durable goods also rose strongly, increasing by 9,5% over the quarter, its strongest growth rate since the second quarter of 1984. In contrast, spending on services declined following two

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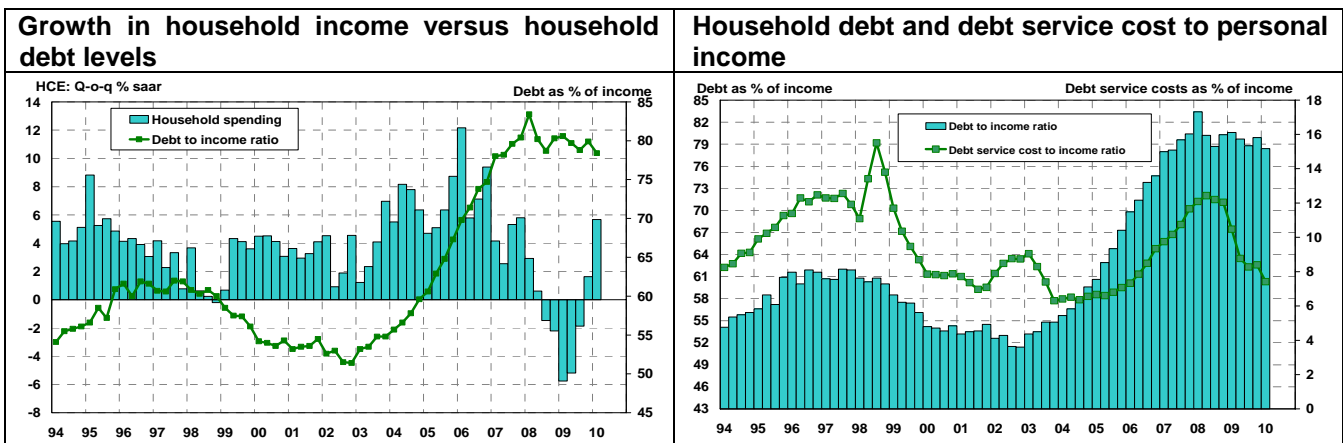
successive quarters of growth, mainly due to a drop in spending on transport services.

Consumer spending trends (Q-o-q seasonally adjusted annualised growth)

(Seasonally adjusted annualised growth rates)												
	2007	Q1'08	Q2'08	Q3'08	Q4'08	2008	Q1'09	Q2'09	Q3'09	Q4'09	2009	Q1'10
Durable goods	1.9	2.0	-20.0	-13.2	-18.9	-7.1	-8.4	-17.6	0.7	15.2	-11.3	16.8
Semi-durable goods	11.3	7.3	3.9	0.0	-0.9	4.2	1.3	-4.8	-7.2	-0.6	-1.5	28.4
Non-durable goods	5.0	2.6	0.7	-2.2	-3.2	1.5	-9.9	-1.7	-5.4	-0.7	-4.4	9.5
Services	5.5	2.3	5.4	1.6	2.3	5.1	-3.4	-5.4	2.0	1.6	-0.6	-4.6
Total	5.5	2.9	0.6	-1.5	-2.2	2.4	-5.8	-5.2	-1.9	1.6	-3.1	5.7

Expenditure by general government rose strongly over the quarter following some moderation in the final quarter of 2009, mainly reflecting the acquisition of two military aircrafts, while higher government salary outlays also contributed.

Encouragingly, while consumers are increasing current spending, they are also taking advantage of low interest rates to repay their existing debt. This is reflected in the reduction of the **household debt to disposable income** ratio, which eased to 78,4% in the first quarter from 79,9% in the last quarter of 2009, while the ratio of interest servicing cost to disposable income eased to 8,2% from 8,3%.



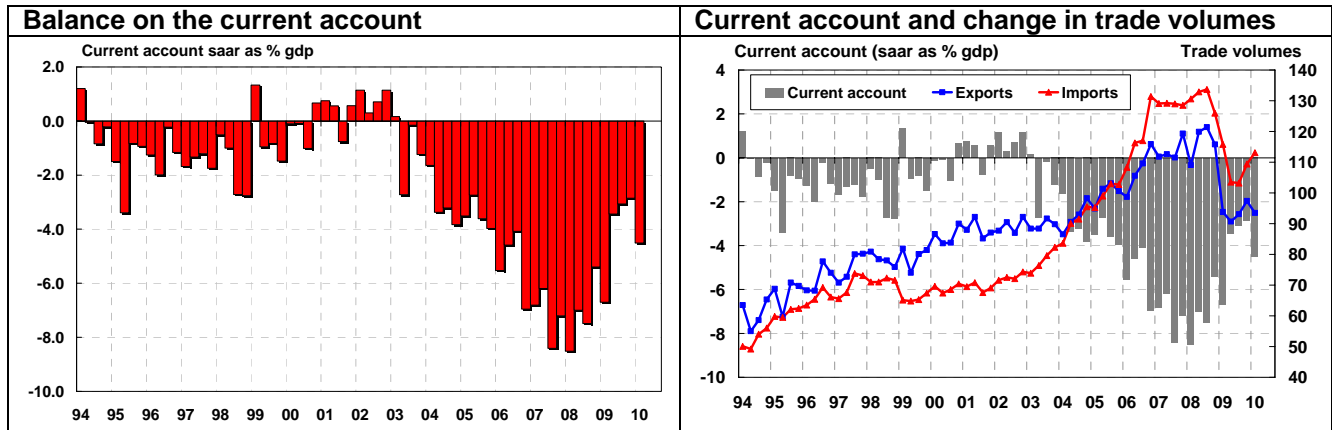
After falling for three consecutive quarters, **gross fixed capital formation** increased in the first quarter, supported by further investment by public corporations, mainly on transport-related projects aimed at the preparations for the FIFA World Cup. Despite some improvement in demand conditions, the **private sector** has been reluctant to undertake more capital spending. Fixed investment in this sector remained weak, although falling at a moderate pace during the first quarter, with the contraction in investment activity recorded in the mining, manufacturing and agricultural sectors. Expansion was recorded in the construction, finance, transport and communication sectors, with investment outlays in the communication sector mainly aimed at improving infrastructure for the World Cup event. **Government fixed investment spending** remained weak during the first quarter, but the rate of decline eased to a seasonally adjusted and annualised 8% q-o-q from 10% in the previous quarter, with all levels of government recording lower capital expenditure during the period.

TRENDS IN CAPITAL FORMATION BY SECTOR

Q-o-q seasonally adjusted annualised rates												
	2007	Q1'08	Q2'08	Q3'08	Q4'08	2008	Q1'09	Q2'09	Q3'09	Q4'09	2009	Q1'10
Mining & quarrying	29.8	-22.3	27.0	25.1	31.7	13.2	3.6	-12.9	-28.4	-12.7	2.7	-5.0
Manufacturing	7.7	22.4	7.4	15.1	-8.4	8.2	-43.9	-17.2	-32.9	-18.8	-20.9	-7.2
Power & water	34.2	63.5	2.0	58.9	43.3	41.9	187.2	101.7	6.4	1.9	69.9	4.8
Transport & communication	15.2	90.2	12.9	13.5	1.8	31.3	56.5	-20.2	11.0	21.2	12.9	8.5
Finance & real estate	6.7	-22.1	6.0	-17.6	-11.6	-8.2	-9.7	-4.3	8.3	-8.8	-7.1	5.3
Community services	19.6	21.5	-5.9	20.4	-1.1	9.0	-14.9	-4.9	-4.8	8.4	-3.3	-12.9
Total	14.2	17.5	7.9	12.4	2.8	11.7	5.2	-2.5	-6.5	-0.9	2.3	0.2
General Government	19.6	16.3	7.9	10.0	3.4	13.4	-3.2	-6.2	-6.9	-10.0	-1.2	-8.0
Public corporations	33.9	58.1	17.3	46.1	-2.1	41.0	147.9	21.7	17.0	8.7	40.7	7.4
Private Sector	9.8	9.7	5.6	5.3	4.0	5.6	-18.1	-9.5	-14.5	-2.3	-7.0	-0.7

Real inventory investment declined further, but at a slower pace, during the first quarter, falling by R8,7 billion and mainly dragged down by a rundown of inventories in the manufacturing sector. However, all the other sectors accumulated inventories over the quarter, boosted by coal inventory accumulation, which rose due to the expected increase in demand during the winter season as well as the overall economic recovery.

Balance of payments – current account



Comment

The **current account deficit** widened to a larger than expected 4,6% of gdp from a revised 2,9% (previously 2,8%) in the fourth quarter. In value terms, the deficit rose to a seasonally adjusted and annualised R116,1 billion from R71,4 billion. A trade deficit coupled with higher net service, income and transfer payments pushed the current account deficit higher.

The **trade account** switched to a R12,9 billion deficit from a R24,9 billion surplus in the previous quarter, mainly due to a drop in both the value and volume of exports, while those of imports rose.

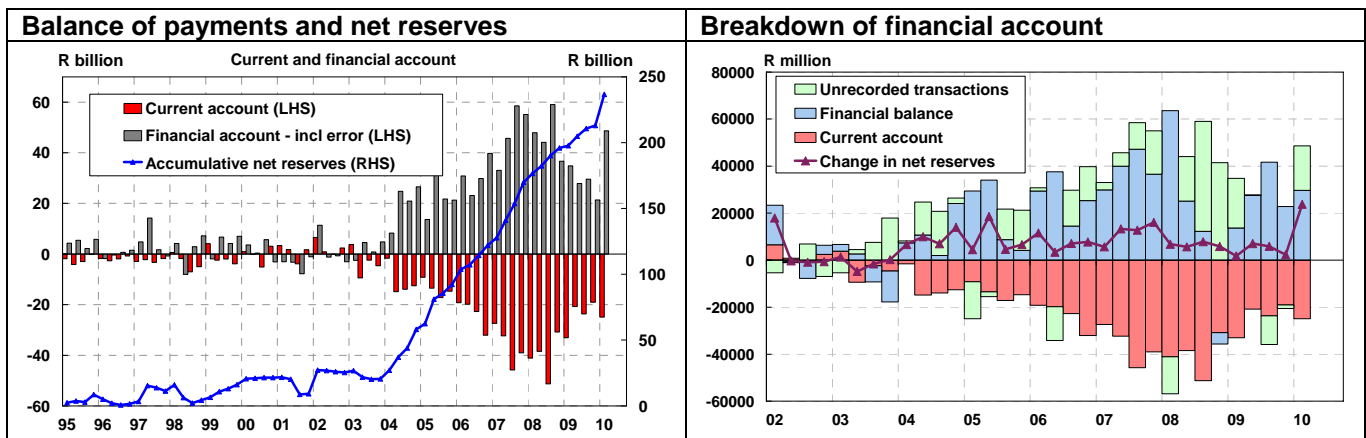
Merchandise exports decreased to a seasonally adjusted and annualised R518,6 billion from R528,5 billion, falling by 1,9% and 3,3% in value and volume terms, respectively. Export prices increased by 1,5% in rand terms during the quarter, while the ratio of exports to gdp dropped to 17,4% in the first quarter from 18,2% in the fourth quarter. Net gold exports decreased to R49,5 billion from R59,2 billion, down by 16,4% in value terms and 16,5% in volume terms as the marginal increase in the international gold price was more than offset by lower gold output and the stronger rand during the quarter.

Merchandise imports rose to R581,0 billion from R562,8 billion, boosted by higher demand from domestic businesses and consumers. The value of imports increased by 3,2%, while the volume rose by 2,7%, boosted by imports of four aircraft (including two by the private sector) and higher international prices. The rand value of imports increased by 0,5% during the quarter as the rise in prices of imported goods more than offset the positive impact of the stronger rand.

The **terms of trade** (the index of export prices over import prices) improved by a further 0,6% after increasing by 1,4% in the previous quarter.

The deficit in the **net service, income and current transfer account** widened to R103,2 billion from R96,3 billion in the fourth quarter. Payments for freight-related services rose in line with higher imports, net travel receipts fell and gross dividend payments increased in line with the recovery in domestic corporate profits.

Balance of payments – financial account



The **financial account** strengthened further as capital inflows more than doubled during the first quarter. **Inflows** (including unrecorded transactions) rose to R48,6 billion from R21,3 billion, with the financial account surplus rising to 7,8% of gdp from 3,4% in the previous quarter and 4,7% in 2009 as a whole.

Net portfolio inflows increased on foreign equity and bond inflows as well as a government global bond issue, while portfolio outflows by domestic investors fell. Net inflows amounted to R38,6 billion from R31,5 billion in the previous quarter, as foreigners invested R44,1 billion in local markets while locals sent R5,5 billion offshore.

Net direct investment inflows amounted to R4,6 billion after outflows of R5,6 billion in the previous quarter. Inward investment was R3,7 billion, while local entities repatriated R900 million of offshore investments.

Net other investment outflows increased to R13,4 billion from R3,1 billion, as local banks partly repaid their foreign loans and deposits by foreigners fell, while South African entities also increased their short-term foreign assets.

Outlook

The local recovery should continue during the remainder of 2010, maintaining the pace set in the first quarter through the middle of the year before easing off in the final quarter. The momentum is likely to come from domestic spending. Households should see further improvements in income as the labour market settles, house prices improve further, interest rates remain low and debt levels become more manageable. These factors should boost consumer spending, while the hosting of the FIFA World Cup will provide an additional boost, both through the direct spending injection of visitors but also by lifting the mood of local consumers, stimulating more compulsive buying. Consumer spending is expected to grow by 2,4% in 2010, with annualised growth rates of 3% and 5% expected over the second and third quarters respectively.

Government consumption expenditure is expected to grow at a slower pace during the rest of the year. Spending may remain brisk in the second and third quarters, propped up by the demands of hosting the World Cup and the roll out of social spending set out in the budget. However, more constraint is likely towards the end of the year as the government attempts to restore finances to good health and reduce the budget deficit to more modest levels over the next three years.

In contrast, fixed capital formation is likely to remain muted. While the private sector is no longer cutting capital expenditure as sharply as that of much of 2009, significant expansion activity is unlikely during the remainder of 2010 as the general mood remains very conservative, doubts about the strength and sustainability of the global recovery continue to linger, and as ample spare capacity exists especially in the mining and manufacturing industries. While government committed R392 billion to capital expenditure over the next three years in the 2010 National Budget, capacity constraints at the lower tiers of government and budget constraints are expected to hamper progress in 2010. Most of the large capacity expansion projects announced by public corporations, especially by Transnet and Eskom are expected to continue, but the rate of spending is forecast to slow as most public utilities are finding it harder to obtain financing due to pressure on cash flows and stretched balance sheets. Consequently, total fixed capital formation is expected to decline by 1,6% in 2010, after slowing to 2,3% growth in 2009. Despite the inventory depletion of the first quarter, which suggests most firms remain very cautious, restocking is still expected to resume albeit at a modest pace later this year.

Exports should still fare better in 2010 than in a very weak 2009, but performance is likely to be patchy and subdued. Doubts about the world economy have flared up again in recent months, with the recovery looking more vulnerable, triggering renewed fears of a double-dip recession. Growth in Europe is likely to suffer as the UK and many other European countries undertake dramatic fiscal adjustments to reduce large budget deficits and cut state debt burdens. Slower growth in Europe will hurt local exports, as the euro zone is South Africa's biggest trading partner, accounting for about a third of export volumes. Demand from the US is unlikely to compensate, with US consumers languishing under heavy debt burdens, high unemployment and growth still very much depends on stimulatory monetary and fiscal policies. Healthy demand for commodities from China and other rapid growing emerging markets should support local exports throughout the year, but the strong surge experienced in mid 2009 is unlikely to be repeated as China tries to cool growth to contain inflation and avoid asset price bubbles. While commodity prices will remain relatively firm, a strong rand is also likely undermine export performance.

However, imports are likely to bounce back relatively strongly during the remainder of the year, mainly boosted by stronger consumer spending and some degree of restocking. Consequently, the trade deficit will probably widen in 2010, but should be contained by a stronger service balance due to the anticipated surge in tourist receipts flowing from hosting the World Cup. All together, the current account deficit is forecast to widen to about 4,5% of gdp from 4% of gdp in 2009, but should still be easily financed given the country's relatively sound fundamentals.

Overall, stronger consumer spending, the injection from the World Cup, and modest restocking should help offset a slight deterioration in the country's net export position, combining to produce gdp growth of around 3,1% in 2010. This growth cycle is likely to be more modest as prospects are likely to be constrained by high levels of household debt, significant infrastructure constraints, government capacity problems, regulatory issues, uncertain government policies and more moderate global growth as households in industrialised countries try to reduce high debt burdens and repair balance sheets while governments attempt to contain public debt.

Implications

The Quarterly Bulletin now shows that domestic spending is recovering off a very low base, but that production is looking slightly more vulnerable following the strong bounce recorded in the second half of 2009. The doubtful global outlook, and especially the debt worries in some European countries, are concerning for South Africa, increasing the chances of possible setback later this year. In sharp contrast, inflation continues to moderate and the outlook remains favourable. Given the balance of risks, the Reserve Bank is likely to prefer keeping interest rates steady and low for as long as possible. We therefore expect interest rates to remain unchanged throughout 2010 and deep into 2011, but if growth was to disappoint and inflation remain tame, there may still be some downside in the short term.

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