

ECONOMICS | SOUTH AFRICA

Nedbank Guide to the Economy



GROUP ECONOMIC UNIT

Isaac Matshego
Johannes Khoza
Nicky Weimar

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The global economic recovery continues steadily, with manufacturing conditions still benefitting from expanding merchandise trade volumes. Supply-side price pressures have intensified as pandemic-related supply chain disruptions persist. The Federal Reserve's shift to an earlier interest rate hike suggests the start of the normalisation of monetary policy across the globe, but conditions will remain accommodative. Overall, risks to global growth are now balanced.

2 | Domestic review and prospects

The economy fared much better than expected in the first half of the year, buoyed by fewer restrictions on economic activity, low interest rates and the robust global recovery. Although conditions deteriorated dramatically in July, rocked by another Covid wave, tighter lockdowns and destructive social unrest, the recovery is, nevertheless, expected to continue. Real GDP is forecast to grow by around 4.2% in 2021, after shrinking by 7% in 2020. Inflation is forecast to remain contained, with some normalisation in monetary policy expected next year.

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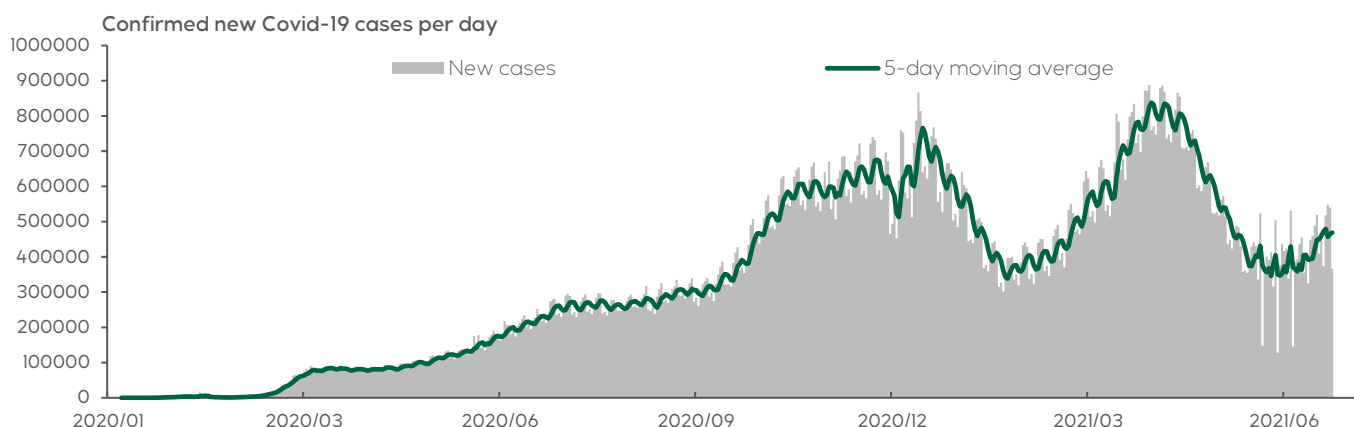
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INTERNATIONAL BACKGROUND AND OUTLOOK

The global pandemic has persisted. The rollout of vaccines continues to facilitate the relaxation of lockdown measures, particularly in countries that have made progress in inoculating their populations. The normalisation of economic activity is supporting a rebound in services in these economies, which are now showing a faster improvement than manufacturing. Globally, trade momentum has remained solid, continuing to boost manufacturing. Pandemic-related supply chain disruptions have stoked inflationary pressures. On the monetary policy front, the US Federal Reserve is leaning towards an earlier-than-previously-indicated start of interest rate hikes. However, global monetary conditions will remain stimulatory for the foreseeable future. Risks to the global outlook are balanced, although the pandemic remains a threat.

Graph 1: Global Covid 19 infections



Source: WHO

The world economic recovery continued as the rollout of Covid-19 vaccines enabled easing lockdown measures across economies that have made progress in vaccinations. The pandemic, however, persists and remains a downside risk to the global recovery. Confirmed global infections have exceeded 185 million, and deaths have passed four million.

Some countries are experiencing a third wave of new infections, which is proving to be more severe than previous waves. India has surpassed the US as the country with the most confirmed cases. However, new infections in India have moderated significantly to around 45 000 from a peak of over 410 000 in the first week of May. The UK has recorded more than 20 000 new cases a day since late June, rising to above 30 000 in the second week of July. European economies have generally contained the virus, although a spike has been visible in Spain and the Netherlands in recent days. Japanese authorities have adopted tighter lockdown restrictions that will ban spectators at the Olympic Games as infections rise. In Latin America, Brazil is still grappling with over 50 000 new cases a day. Transmissions have started to decline in Argentina and Colombia. However, they remain above the peaks of the second waves. Added to this, a fast-spreading strain first detected in Peru has penetrated 27 countries. Deaths in Indonesia have risen to a new high, with more than 30 000 new cases a day. In South Africa, excess deaths have reached a six-month high, suggesting that Covid-related deaths are higher than official reports.

Vaccination rates varied across the globe. The large industrial economies and some smaller, high-income nations have made considerable progress. However, none of them has reached herd immunity (67% of the population fully inoculated). This milestone has been achieved only by the tiny island nation of Seychelles – population 98 969. The US has fully vaccinated more than 150 million of its 320 million people. Similarly, the UK and Israel have vaccinated 50.5% and 57.2% of their populations, respectively. These countries, together with Canada (36.6%), Germany (38.93%) and France (33.7%), are on course to achieve herd immunity by the end of the third quarter. China (15.9%), Mexico (15.5%) and Brazil (13.3%) are also making steady progress.

Australia and New Zealand are lagging, with only 7.4% and 9% vaccinated. However, both nations have managed to contain the pandemic, with confirmed cases averaging only 0.1% of their populations. India and Indonesia have so far fully vaccinated 4.7% and 5.2% of their people. In Sub-Saharan Africa, vaccination rates are still in single digits as financial and logistical constraints delay the process. The shipment of vaccines to developing nations across the globe by the World Bank's Covax facility has been slow, with just over 95 million doses disbursed to 134 countries by early July. The Group of 7 has committed to donating 870 million doses to these countries, with the US's committing 500 million doses. Half of this allocation will be shipped before the end of this year.

Economies that are making significant progress in inoculating their populations, many of which also benefit from expansionary fiscal and monetary policies, will recover faster as they ease lockdown measures. The UK will lift all remaining Covid restrictions on 19 July, and the other nations will follow suit. However, new variants of Covid-19 may test the effectiveness of the vaccines. Any setback on this front would disrupt the normalisation of social and business activities, dimming the global economic outlook.

Global monetary policy will remain accommodative for the foreseeable future. However, the focus is increasingly shifting to when the ultra-stimulatory policies will be scaled back. The US Fed has hinted that it is likely to raise its target for the federal funds rate twice in the second half of 2023, which is a year earlier than indicated in its previous forward guidance. Minutes of the Fed's June policy meeting suggest that the central bank will start tapering its \$120 billion-a-month bond-buying programme sometime in 2022 in response to the solid economic recovery, enabled by the normalisation of most economic activity. The European Central Bank (ECB) has indicated that it will tolerate inflation above its 2% target until a more solid Eurozone recovery is underway. It will also maintain bond purchases at its current level until March next year. The Bank of England will look through the rise in inflation to above its 2% target and maintain a cautious approach to monetary policy normalisation. The Bank of Japan will stick with its ultra-easy policy and likely extend pandemic-relief programmes to back a fragile economic recovery.

The Reserve Bank of Australia will extend its bond purchase programme to November after it expires in September. It has indicated that its policy interest rate is likely to remain unchanged well into 2024 even though the economy has returned to its pre-pandemic level and the labour market is buoyant. New Zealand is on course to start hiking before the end of 2021 as the inflation rate is at the upper end of the 1%–3% target band.

In emerging markets, Brazil raised its policy rate further to 4.25% from 2.75% as the inflation rate increased to 8%, well above the upper limit of the 1.5%–4.5% target band. Mexico hiked to 4.25% from 4%, while Hungary raised to 0.9% from 0.6%. The Turkish central bank has hiked its policy rate to 19% from 17.5% after the expulsion of the central bank governor in March stoked fears of a return to unorthodox policy. However, doubts remain over how long the central bank will hold off against government pressure to cut interest rates, despite high inflation and a weak currency.

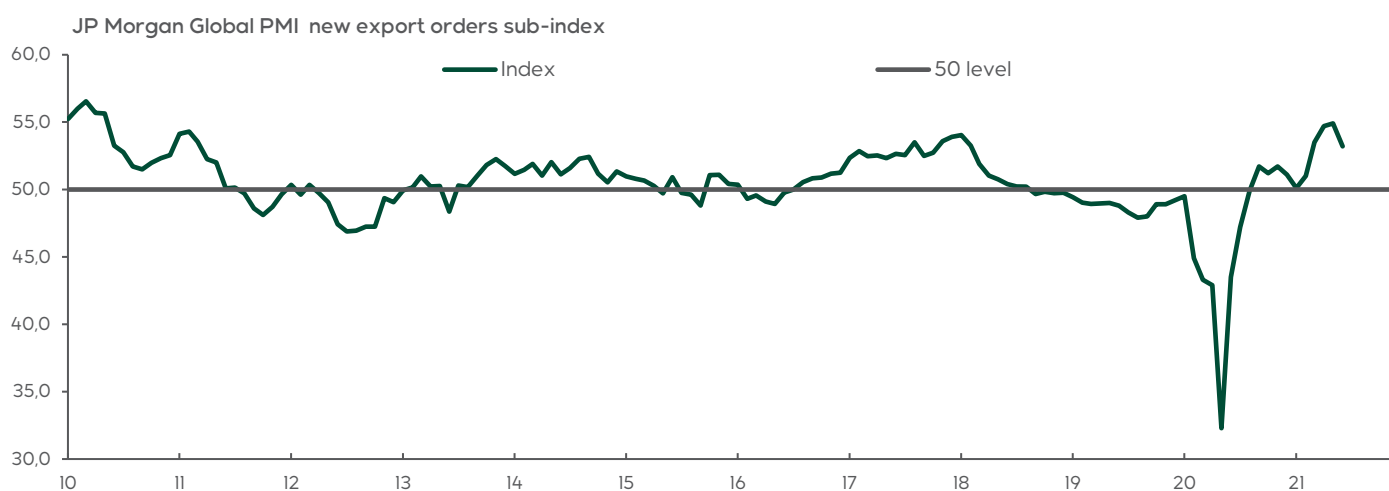
Global economic conditions improved further in the second quarter. The JP Morgan global composite purchasing managers index (PMI) of manufacturing and services activity reflected faster growth in services than in manufacturing for the third successive month in June. Global employment rose for the 10th consecutive month, reaching levels last seen before the 2008 global financial crisis. The services PMI touched a 15-year high of 59.6 in May before easing marginally to a still robust 57.5 in June, buoyed by robust recoveries in the US, Ireland, Spain, and the UK. Similarly, country-level data also reflect substantial recoveries. The US Fed's

Beige Book showed a healthy rise in leisure travel and restaurant spending in recent months. The UK reported firm trends in consumer-facing services since restrictions on such activities were relaxed in April.

All economies surveyed recorded expansions in services activity, except for Japan and India. Only China and India did not record improving services employment. These trends are consistent with the International Air Transport Association's (IATA) anecdotal report of a steady but slow pick up in passenger travel. However, the pickup remains concentrated in domestic air travel, which was still 23.9% lower in May than in the same month in 2019.

Manufacturing activity remained buoyant in the second quarter, despite persistent supply chain disruptions in some industries. For instance, the global semiconductor shortage has forced some US carmakers to cut production. Overall, manufacturing conditions continued to be bolstered by the brisk expansion in global trade volumes. PMIs in the large industrialised economies remained above 60, offsetting generally subdued conditions in developing economies. New export orders eased marginally but still pointed to steady demand for manufactured merchandise

Graph 2: Global manufacturing conditions remained favourable



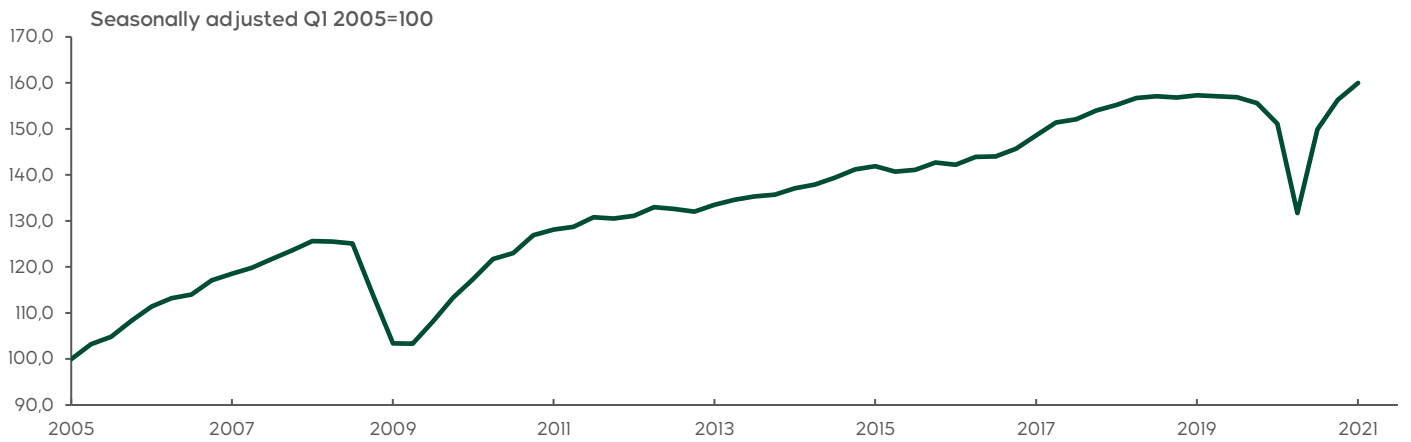
Source: Markit Economics

The global manufacturing PMI, the weighted composite PMI of industrialised and developing economies, which account for 98% of global manufacturing value added, was above the 10-year high of 55 throughout the quarter, buoyed by PMIs above 60 in the US, Germany, Italy, the Netherlands, Austria, Ireland, the UK and the Czech Republic. Canada, France, Brazil, Australia, Greece, South Korea and Indonesia. Taiwan's PMI fluctuated around the 55-level. The Japanese PMI was above 50 for the fifth successive month as firm Asian demand pulled the country's largest sector out of a slump that started in late 2018. The large developing economies reflected a mixed picture, with mildly favourable conditions in China and a contraction in India. The official Chinese PMI of large, state-owned factories and the Caixin PMI of smaller, privately-owned enterprises hovered around 51. The Indian PMI dipped to 48.1 in June, falling into mild contraction territory as the pandemic and stricter lockdown measures disrupted supply chains. The pandemic is still devastating economic activity on some of the smaller, trade-dependent economies. Manufacturing activity in Malaysia and Thailand remained depressed due to pandemic-related disruptions.

Global PMI subindices continued to reflect broad-based improvement during the second quarter. Manufacturing employment rose in most economies, albeit marginally. China and Brazil, which experienced job shedding into 2021, started to boost hiring, but job losses persisted for the 15th consecutive month in India. Worryingly, global inflationary pressures have risen as tight global supply chains push production costs higher. Global input prices exceeded 70 throughout the quarter and fed through to higher selling prices. The US ISM prices-paid subindex reached 92.1, its highest level since the oil price induced spike in 1973. In the UK, input prices jumped to a record high while selling prices rose at the fastest pace since the start of the survey in November 1999. German cost prices set new record highs over four successive months. Chinese input inflation remained high despite easing to a seven-month low in June. The Brazilian input prices subindex was close to the record high (since the data was collected from 2006) due to raw material shortages.

Indicators of global merchandise trade are still pointing to rising volumes despite supply chain disruptions in some industries. In April, the CPB Netherlands Bureau of Economic Policy Analysis's index of merchandise trade volumes was 25.3% higher than 12 months earlier and 5% above the April 2019 level. According to the World Trade Organisation's seasonally adjusted index, world merchandise export volumes have surpassed their pre-crisis levels. At the same time, IATA's measure of global air cargo increased for the 13th consecutive month in May, up 9.4% compared with May 2019.

Graph 3: World merchandise volumes above pre-pandemic levels



Source: Markit Economics

The US labour market continued to strengthen at a reasonably solid pace. Nonfarm payrolls were up by 850 000 in June, taking the job gains for the second quarter to 1.7 million from a 1.5 million increase in the previous quarter. This brought the recovery in non-agricultural jobs to 16.6 million, still short of the 22.4 million jobs lost at the height of the strict lockdown of March and April last year. The unemployment rate has remained sticky at 5.9%, as better economic prospects boosted the labour participation rate. The four-week moving average of initial jobless claims declined to its lowest level since mid-March 2020. The Fed's Beige Book reported a moderately faster expansion in economic activity over the six weeks to late May compared with the prior comparable period, boosted by the positive effects of accelerated vaccinations and easing restrictions. Consumer and business confidence improved further, with the latter reaching a two-year high. However, supply chain disruptions limited the pace of improvement.

The Federal Open Market Committee expects slightly firmer growth over the period to 2023. It forecasts real GDP growth of 7% y-o-y in the final quarter of 2021, better than the 6.5% projected in March. Growth will then ease to an estimated 3.3% in 2022 and 2.4% in 2023, remaining above the longer-run average of 1.8%. Its inflation forecast rose to 3.4% (from 2.4%) for 2021. The rise in inflation is still considered transitory, with inflation easing to 2.1% and 2.2% over the following two years, respectively. The job market will continue to strengthen at a steady pace. The unemployment rate is projected to dip to 4.5% in the final quarter of this year and to 3.8% and 3.5% in 2022 and 2023, respectively

Graph 4: Steady return of US jobs



Source: FRED

The recovery in the Eurozone is gathering pace. Job creation has picked up, with the unemployment rate easing further. Core retail sales (excluding food and fuel) and industrial production rebounded after the second wave-related setback of late-2020 to early-2021. However, the Eurozone's recovery still lags behind the US and the UK, due to varying rates across the 19 economies, with the exporting economies leading the upturn. German business sentiment indicators continue to show optimism, with exporters

planning to boost output in the Eurozone's largest economy. Industrial output is trending higher in France and Italy in line with their PMI indicators.

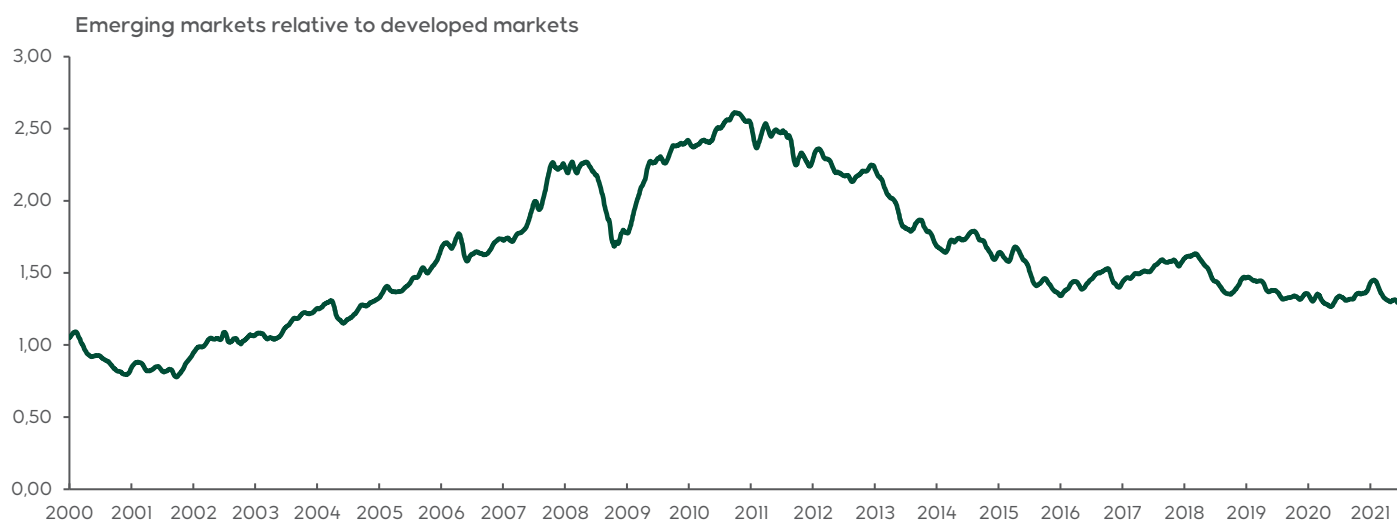
The UK labour market is strengthening, underpinned by the acceleration in economic activity. The unemployment rate has moderated to less than 5%, while private sector regular wages were 5.6% higher in the three months to April than over the same period in 2020. Unemployment, however, is expected to rise temporarily after the end of the jobs support programme in September.

Japanese exports accelerated sharply in April and May, boosted by higher shipments to the US and China. The production of capital equipment also increased, supported the easing of lockdown measures and strong global demand.

Sub-Saharan African (SSA) economies have not taken advantage of high commodity prices, primarily due to logistical constraints. Nigeria and Angola will not boost their oil output significantly after OPEC+ raised their production quotas. An unfavourable business environment, worsened by electricity shortages, has inhibited higher export earnings in Zambia, despite elevated copper prices. Logistical difficulties and limited supply are also affecting the rollout of Covid-19 vaccines. The Covax facility has allocated doses to SSA nations, ranging between 20 000 for the small populations and up to 2 million doses for the larger nations. Initial shipments have been made to 38 of the 54 countries. The subcontinent is particularly vulnerable to the more infectious variants of Covid.

Risk-on sentiment boosted riskier asset classes further over the second quarter. Equities outperformed bonds. Developed market equities outperformed their emerging market counterparts, benefitting from solid corporate earnings growth. Emerging market currencies surrendered a portion of their large gains after the Fed hinted at a shift in its stance in mid-June. The MSCI World Index (\$) and the MSCI Emerging Markets Index (\$) were up 7.3% and 4.4%, respectively.

Graph 5: In equity markets, developed markets outperformed emerging markets



Source: Morgan Stanley Capital Index

In the US, the S&P 500, the Dow Jones Industrial Average, and the Nasdaq set fresh record highs in the second week of July, adding to their impressive 12.8%, 11.5% and 9.9% second-quarter gains. The German Dax and the French CAC gained 12.7% and 14.1% respectively, while UK's FTSE100 was up by 8.5%. Japan bucked the trend, shedding 0.6% for the quarter, weighed by concerns over high Covid cases. Among emerging markets, Asia Pacific (excluding Japan) was up by 3.4%, while emerging Europe and Latin America rose by 12.1% and 13.8%, respectively. South Africa (\$) was down by 1.9% primarily due to currency losses.

In currency markets, the US dollar reversed its course after the June Fed meeting to end the quarter at \$1.19 against the euro, after touching \$1.23 in early June from \$1.18 at the end of March. The dollar firmed to \$1.38 against the British pound from 1.43 in late May. The Japanese yen eased to ¥111.5 against the dollar from ¥109.4. Commodity and emerging market currencies were firmer through most of the quarter, but some lost most of their strength after the Fed's June meeting.

In commodity markets, the Brent crude oil price rose by 14.2%, moving to within a whisker of \$80 a barrel, up by 48% year to date. Disagreements about production quotas within OPEC+ have stoked fears of higher prices and some producers leaving the cartel.

Graph 6: Brent crude oil price has edged higher



Source: Refinitiv

In the precious metals market, gold was largely steady, gaining 2.1% for the quarter, while platinum lost 10.7%. The copper price breached \$10 000 per metric tonne in the final week of May as it reached a historical high but gave up some of these gains to end at \$9 351, up by 6.4% over the quarter. Firm industrial activity will continue to support copper prices.

Food prices are more than a third higher than their level a year ago. The Food and Agricultural Organization's food price index gained 4.6% q-o-q and 37.4 y-o-y in the second quarter. Prices of food oils, sugar, cereals, dairy products, and meat appreciated by 101.6% y-o-y, 42.5% and 37.4%, 23.2% and 13.3%, respectively. Soybean and maize prices are up by 86% y-o-y and 111%, respectively. Developing economies, highly reliant on food imports, face the prospect of even higher prices as the effects of numerous shocks continue to pressure food supply. The International Monetary Fund stresses that world food supply is feeling the effects of the outbreak of African swine fever among China's herd in 2018 and the impact of higher trade tariffs imposed by the US and China during their 2018 trade war. Global restrictions on the movement of people and goods to contain the spread of the coronavirus also disrupted agricultural supply chains, while higher shipping costs and the rise in global fuel prices have raised transport costs. Dry conditions in key cereal producers in Latin America (Argentina and Brazil), Russia, Ukraine, and the US are adding further pressure. In southern Africa, key producers Namibia and Zambia need to import food due to dry conditions in their agricultural areas.

Isaac Matshego

DOMESTIC REVIEW AND PROSPECTS

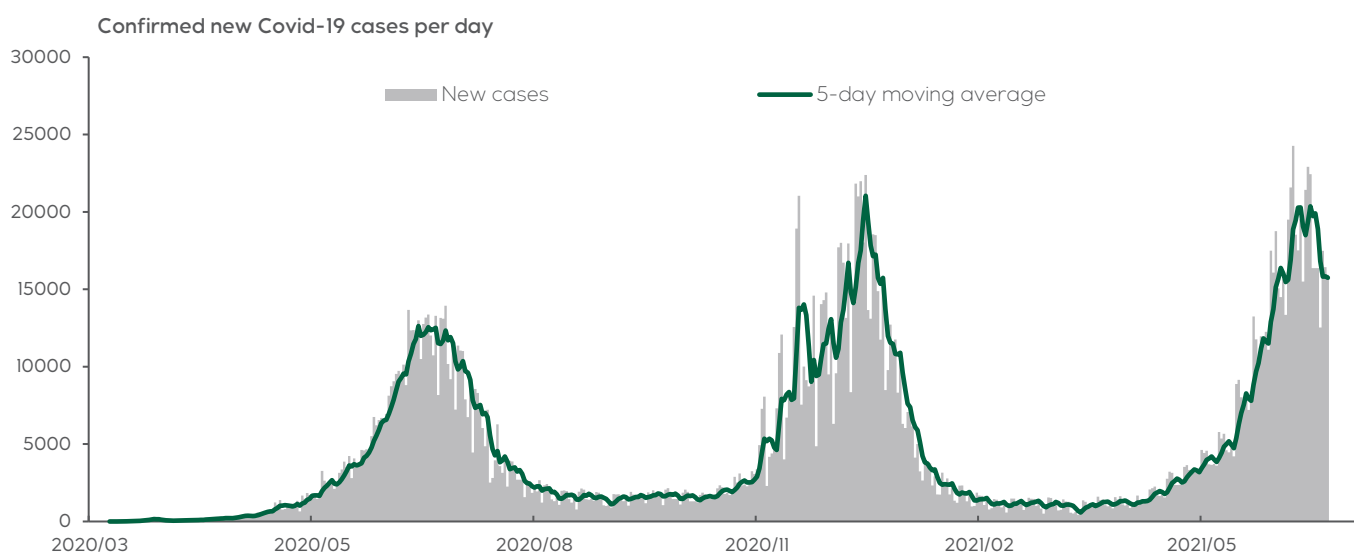
The economy fared better than expected in the first half of 2021 as low interest rates, less stringent lockdown restrictions, and subdued inflation supported consumer spending. The continued recovery in global demand and surging commodity prices underpinned the export earnings. In contrast, fixed investment remains weak, undermined by uncertain growth prospects, ample spare capacity, frequent power outages and the threat of new viral outbreaks and lockdowns. The country officially entered a third wave of Covid-19 infections in June, resulting in stricter lockdown rules. Added to this, parts of the country were thrown into disarray by destructive riots in recent days. Although the economy will remain vulnerable to future Covid surges, recurring lockdowns and subdued confidence in the aftermath of the unrest, it is unlikely to completely derail the recovery as long as calm is restored relatively quickly, and a repeat of the severe economic shutdown of 2020 is avoided. Given the better-than-expected growth outcomes of the first half of the year, we have revised our GDP forecast for calendar 2021 up 4.2% from 3.8%. The Reserve Bank's Monetary Policy Committee will likely raise the policy interest rate marginally in the final quarter of this year as global liquidity and monetary conditions gradually normalise.

The virus continues to disrupt South Africa's recovery. The country is currently in the grips of a third wave of infections, dominated by the delta variant of Covid-19, which was first identified in India. The number of new infections recorded so far in the third wave is higher than in the previous two waves. On 2 July, new cases per day reached a record high of 24 270, compared with a peak of 21 980 during the second wave. In response, the government tightened restrictions to an adjusted level 3 on 15 June and adjusted level 4 on 28 June. The new rules are similar to level 3, targeted to limit human contact, including an outright ban on the sale of alcohol, social gathering, sit-in dining and interprovincial travel for individuals.

The pace of vaccination remains slow, which means that government will probably miss its target to achieve herd immunity by 2022. The initial plan was to immunise 41 million people by the end of 2021. To date, around 3.6 million people have been immunised, of which some people would need to take more than one dose to be fully vaccinated.

The stricter lockdown and the destructive social unrest are likely to disrupt but not wholly derail the recovery. This was the case during the second wave from late December to the end of January. The move to an adjusted level 3 lockdown, which also included a ban on alcohol sales, resulted in weak output and sales outcomes in January, followed by a robust rebound in February and March. As a result, growth continued, with real GDP expanding by a further 4.6% q-o-q (seasonally adjusted and annualised rates) in the first quarter, after recovering at rates of 5.8% and 67.3% in the fourth and third quarters of 2020, respectively.

Graph 7: Covid-19 continues to threaten the recovery



Source: WHO

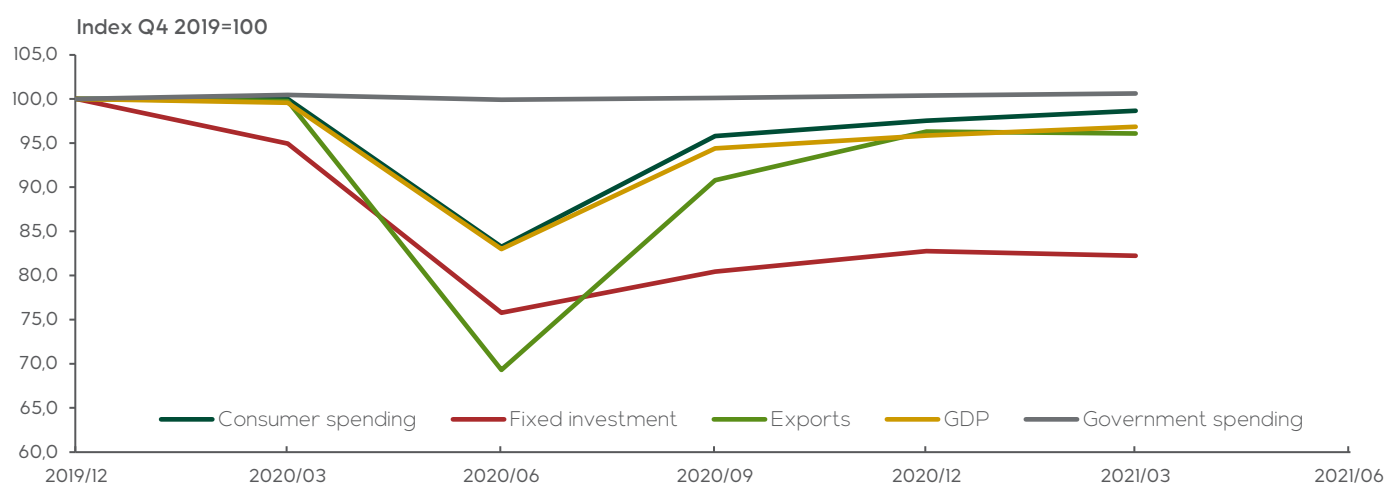
Table 1: GDP breakdown by sector

Industries	Size	Annual growth rates (%)			Quarterly Growth					
		% of GDP	Y-o-y % change			Q-o-q % change (saar)*				
			2020	2018	2019	2020	Q1'20	Q2'20	Q3'20	Q4'20
Agriculture	2.4	-4.8	-6.9	13.1	38.8	22.0	20.1	5.9	-3.2	
Mining	7.5	-1.7	-1.9	-10.9	-22.1	-70.8	271.2	-5.7	18.1	
Manufacturing	11.5	1.0	-0.8	-11.6	-8.2	-74.7	212.9	21.1	1.6	
Power & water	3.4	0.9	-2.0	-5.0	-5.6	-36.4	58.0	2.2	-2.6	
Construction	2.8	-1.2	-3.3	-20.3	-5.9	-76.8	73.6	11.2	0.8	
Domestic trade	13.2	0.6	0.0	-9.1	-0.7	-67.6	137.0	9.8	6.2	
Transport & comms	8	1.6	-0.4	-14.8	0.8	-69.5	78.1	6.7	4.8	
Finance	17.7	1.8	2.3	-4.4	3.1	-35.7	17.0	-0.2	7.4	
General government	17.3	1.3	1.7	0.7	1.4	-1.0	1.0	0.7	0.9	
Personal Services	5.3	1.0	1.0	-2.3	0.6	-31.7	38.7	4.8	1.7	
Value added	89.1	0.7	0.2	-6.8	-1.6	-50.5	64.4	5.0	4.7	
GDP	100	0.8	0.2	-7.0	-1.8	-51.7	67.3	5.8	4.6	

Source: Statistics South Africa

While most sectors contributed to growth in the first quarter, the momentum came from mining, finance, and domestic trade. More robust global demand and surging commodity prices boosted mining production. At the same time, firmer household incomes and low interest rates sustained the recovery in consumer spending, which carried finance, real estate, business services and domestic trade to higher ground. Turnover in the industries directly affected by Covid restrictions declined sharply in January before bouncing back as the second wave ebbed. Liquor production and food services recovered quickly, but the rebound in hotels and other accommodation was far less vigorous due to the devastating impact of the pandemic on global tourism.

Graph 8: Expenditure breakdown of GDP

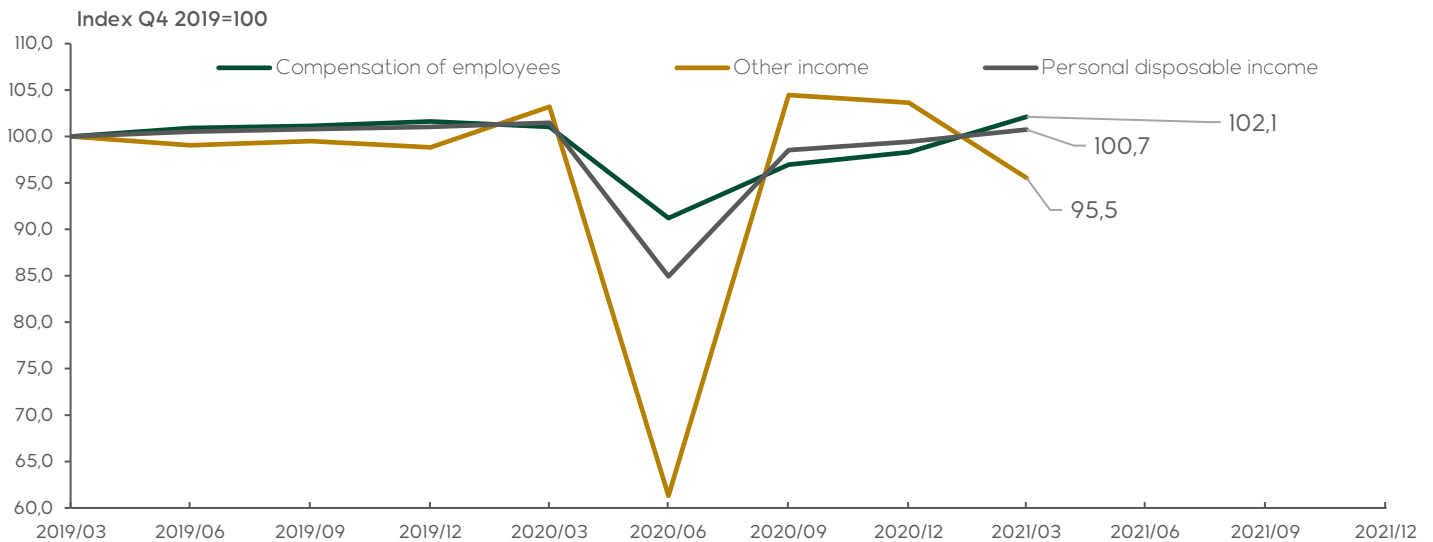


Source: Statistics South Africa

Consumer spending rose by a further 4.7% in the first quarter, supported by continued growth in personal disposable income, which rose by an annualised 5.4% over the quarter and was 1% higher than in the first quarter of 2020, before the pandemic struck. The boost to household incomes came from higher compensation of employees, which accounts for almost 80% of personal income. The impact of the second wave was most visible in the relapse in other sources of household income, including profits, rents and interest.

Remarkably, employee compensation returned to pre-pandemic levels despite the dismal conditions in the labour market. While 847 000 people found employment since April 2020, the economy was still short a massive 1.4 million jobs compared to the first quarter of last year. The number of discouraged workers, those who have stopped looking for work altogether, has increased throughout to 3.1 million in the first quarter of this year, the highest level recorded since Labour Force Survey started just over 12 years ago. As a result, the unemployment rate crept up to a record high of 32.6% in the first quarter.

Graph 9: Key components of personal disposable income

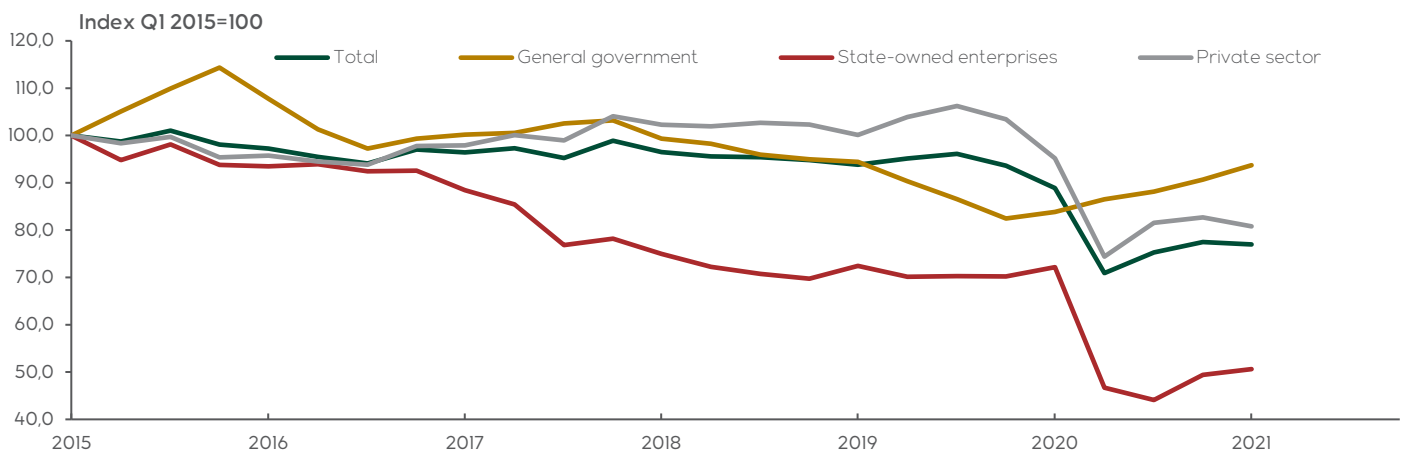


Source: South African Reserve Bank

Households remained cautious, though, opting to restore savings and limit borrowing as a hedge against uncertainty. Household savings rose to 0.7% of disposable income in the first quarter, while debt burdens were steady at 75.3% of income. Net wealth levels also improved, jumping to 387% of household income. The resurgence in equity prices and measured growth in house prices lifted assets while subdued borrowing kept liabilities in check.

The government also continued to lean against the wind, upping consumption expenditure by a moderate 1% over the first quarter. The bulk of spending was on the compensation of employees, which hopefully reflected the recruitment of health care workers to manage the second wave and the vaccination programme. If not, it would directly contradict the plan to reduce the bloated public sector.

Graph 10: Trends in fixed investment activity



Source: Statistics South Africa

While spending by households and government kept the wheels turning, fixed investment contracted in the first quarter, shrinking by 2.6% q-o-q, after managing only modest improvements from the depths of lockdown in the second half of last year. The drag came from lower private sector outlays, which account for the bulk of fixed investment in the economy. This reflected the

underlying lack of business confidence, not only due to the threat posed by Covid-19 and recurring lockdowns to economic growth, but also due to slow policy reforms and persistent power outages. Encouragingly, fixed investment by the public sector improved further. Government stepped up capital expenditure for the fourth consecutive quarter, while outlays by public corporations increased by 10.3% q-o-q, but from an almost non-existent base.

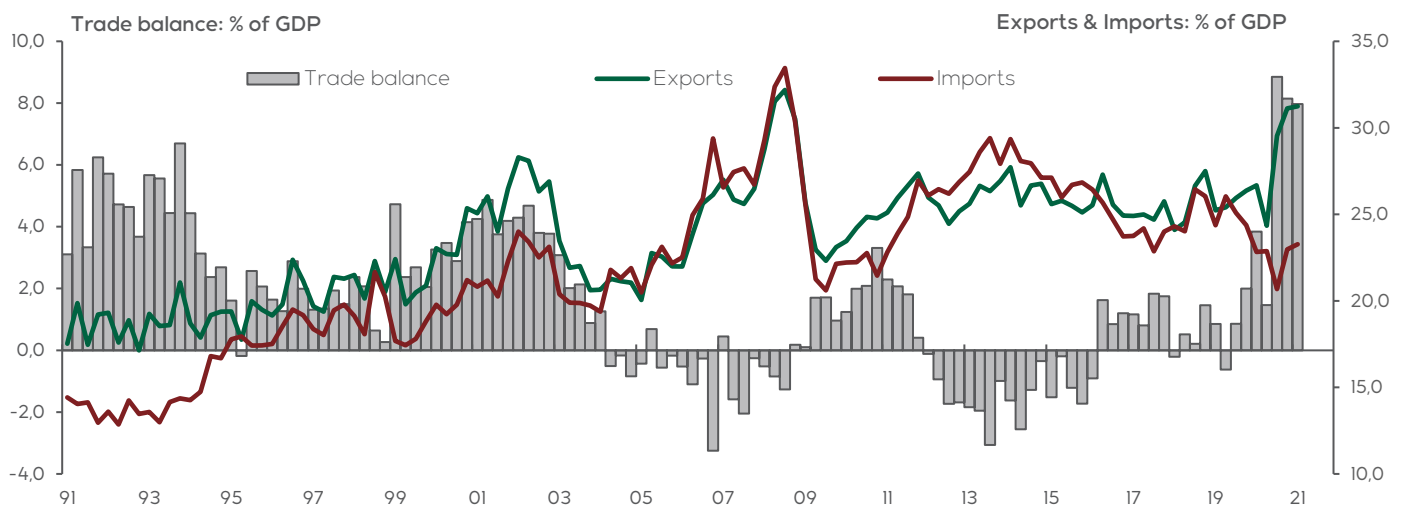
The recovery probably continued at a slower pace over the second quarter. Covid infections were steady at lower levels, and there were fewer restrictions on economic activity. However, with many industries completing the steepest part of the climb from last year's deep trough and returning to around pre-pandemic output levels, the pace of recovery from one quarter to the next is likely to slow or normalise from the higher base. Added to this, underlying conditions started to deteriorate in June, undermined by frequent power outages and rising Covid infections.

More uncertainty surrounds the outlook for the third quarter, when the country was rocked not only by the third wave and tighter restrictions, but also by destructive riots and looting in parts of the country. Social unrest erupted over 9 July to 14 July, triggered by the imprisonment of former president Jacob Zuma for contempt of court, before morphing into a chaotic and violent looting spree. The worst of the unrest appears to be over, possibly subdued by the deployment of the South African National Defence Force troops. The damage is most acute in KwaZulu-Natal, followed by Gauteng, where the unrest was at least isolated to certain areas. Shopping centres, stand-alone shops and warehouses were ransacked and vandalised, trucks were torched, roads were blocked, and communication towers were damaged. The destruction to businesses and the disruptions to transport networks could trigger further job losses and short-term fuel shortages. It could also take longer than normal to rebuild due to the pandemic. Over the short term, these events will translate into sharp declines in production and output in July. Thereafter, economic activity should improve, gathering a mild pace in the final quarter.

The recovery will remain uneven, with the momentum coming from consumers and exporters. While confidence will remain fragile and job creation slow, consumer spending will be buoyed by firmer household incomes, accumulated savings, higher wealth levels and low interest rates. Exports will be propped up by robust global demand and high international commodity prices. However, the country's ability to up production volumes and fully exploit the global upswing is limited by years of underinvestment in new capacity due to policy uncertainty and other legislative obstacles, severe electricity shortages, inadequate transport networks and constrained port capacity. The recent unrest is likely to aggravate these constraints, which coupled with the threats of the virus and lockdowns, will prevent a meaningful recovery in fixed investment over the quarters ahead.

Given last year's low base and the stronger-than-expected outcomes in the first half of the year, we revised our GDP forecast for 2021 up to 4.2% from 3.8% previously. The outlook for next year is still clouded by the presence of the virus and the threat of recurring lockdowns due to the slow pace of vaccinations. Other inhibiting factors include the electricity shortage, other infrastructure constraints and social instability. Our forecast assumes some, but not sufficient, structural reform, which will take some time to have a meaningful impact on the economy. Therefore, GDP growth is forecast to moderate off this year's higher base to 2.1% in 2022 and 1.6% in 2023. There have been some encouraging global developments that could lift domestic growth prospects over the longer term. The focus among developed countries, particularly the US, on rebuilding infrastructure and accelerating the transition to green energy- and transport systems to mitigate climate change could sustain the demand for commodities. These trends could encourage greater fixed investment, but only if the country manages to lift the most pressing infrastructure defects. On this front, recent initiatives to address the electricity crisis are positive. Some municipalities can now buy electricity outside of Eskom, while private companies can generate up to 100MW of their own electricity.

Graph 11: The trade balance widened significantly.



Source: Statistics South Africa

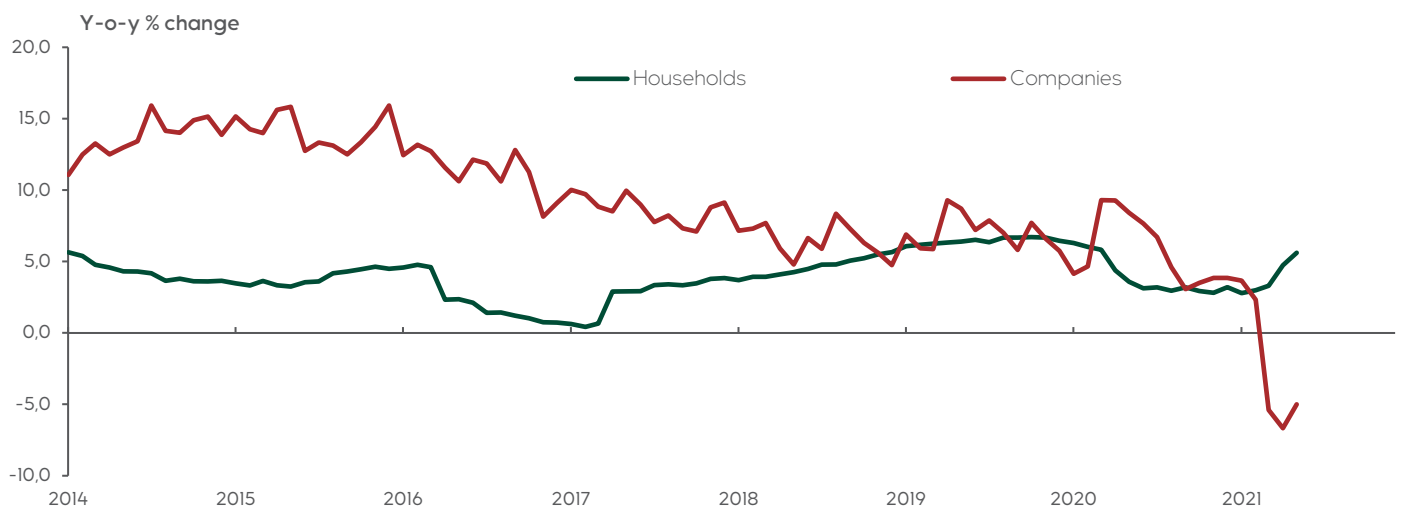
The country's external position strengthened in the first quarter. The current account surplus widened further to 5% of GDP from 3.7% and 5.9% in the fourth and third quarters of 2020, respectively. The improvement reflected a wider trade surplus, combined with a narrower deficit on the services, income, and current transfer account. The trade surplus rose to 8.1% of GDP on a stronger terms of trade (export prices rose more than those of imports). The surge in international commodity prices boosted export values, but export volumes declined. Reversely, import values were propped up by higher volumes driven by the pickup in economic activity, while the stronger rand offset the impact of higher oil prices completely. The deficit on the services, income and current transfer account narrowed to 3.1% of GDP due to sharply lower dividend payments.

Export growth is likely to moderate in the quarters ahead. Capacity constraints, aggravated by persistent power outages, will limit export volumes. The impressive rally in commodity prices is also expected to lose steam over the short-term, contained by softer growth in China, but medium- to longer-term prospects remain encouraging. On the import side, demand for consumer goods will rise, but this will be offset by subdued demand for capital goods on the back of weak fixed investment by the private sector. The services account will underperform for as long as foreign travel restrictions persist. We forecast the current account to record a smaller surplus equivalent to 1.2% of GDP in 2021 compared with 2.2% in 2020.

The deficit on the financial account widened further to a record high at 5% of GDP in the first quarter from 4.4% and 4.5% in the fourth and third quarters of last year, respectively. The drag came from net portfolio outflows, worsened by net outflows of financial derivatives and other investments. In contrast, direct investment inflows were recorded on a smaller scale than in the final quarter of 2020. The net portfolio outflows resulted from resident purchases of foreign debt securities and the redemption of an international bond by a public corporation, which more than offset net foreign purchases of domestic bonds and equities.

Net capital flows will become more volatile during the rest of this year and next year. The remarkable recovery in the US economy, coupled with rising inflation, is likely to result in an earlier normalisation of its ultra-accommodative monetary policies. Once the US starts to taper bond purchases, expected next year, global risk appetites will likely recede, potentially hurting capital flows to emerging markets. The fragile state of the local economy and the country's poor fiscal metrics will also exert pressure.

Graph 12: Credit extension remains weak



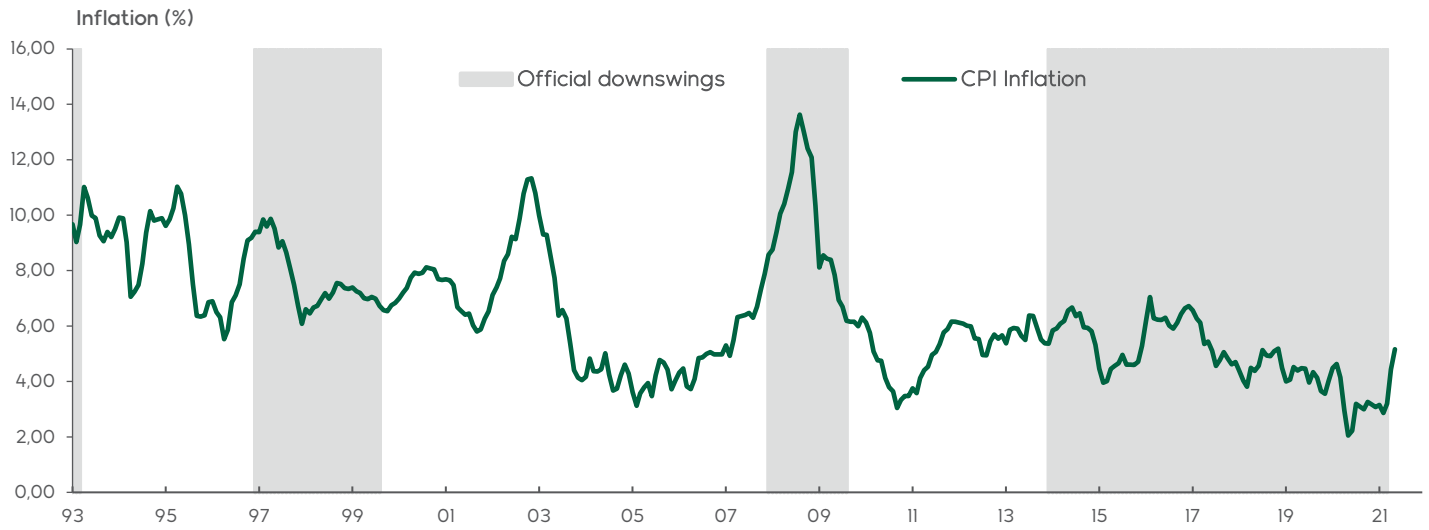
Source: South African Reserve Bank

Private sector credit extension remained weak, but the rate of decline moderated to 0.4% y-o-y in May, after shrinking by 1.6% in March, an 11-year low from modest growth of 3.6% at the end of last year. Despite the dismal picture, there were green shoots. The gradual recovery in household credit demand gathered some pace. Loans to households accelerated to 5.6% y-o-y in May, up from 3.2% at the end of last year. Improved household finances, coupled with subdued inflation and low interest rates, underpinned growth in instalment sales, home loans and credit cards. Personal loans also turned the corner, but households continued to avoid overdrafts. The drag came from weak corporate credit demand. There is no appetite to expand capacity in these uncertain times. Loans to companies declined by 3.9% y-o-y in May, after shrinking by 0.7% at the end of last year. The slump in general loans and overdrafts, the bulk of company loans, deepened. At the same time, growth in commercial mortgages, instalment sales and leasing finances slowed significantly.

Credit growth is forecast to improve moderately during the second half of the year. The impetus will continue to come from households, supported by low interest rates. Corporate credit demand should also turn the corner. Underlying demand will remain

weak, particularly after the social unrest of recent days, with the focus of companies on restoring profitability and strengthening balance sheets.

Graph 13: Inflation still contained by subdued demand

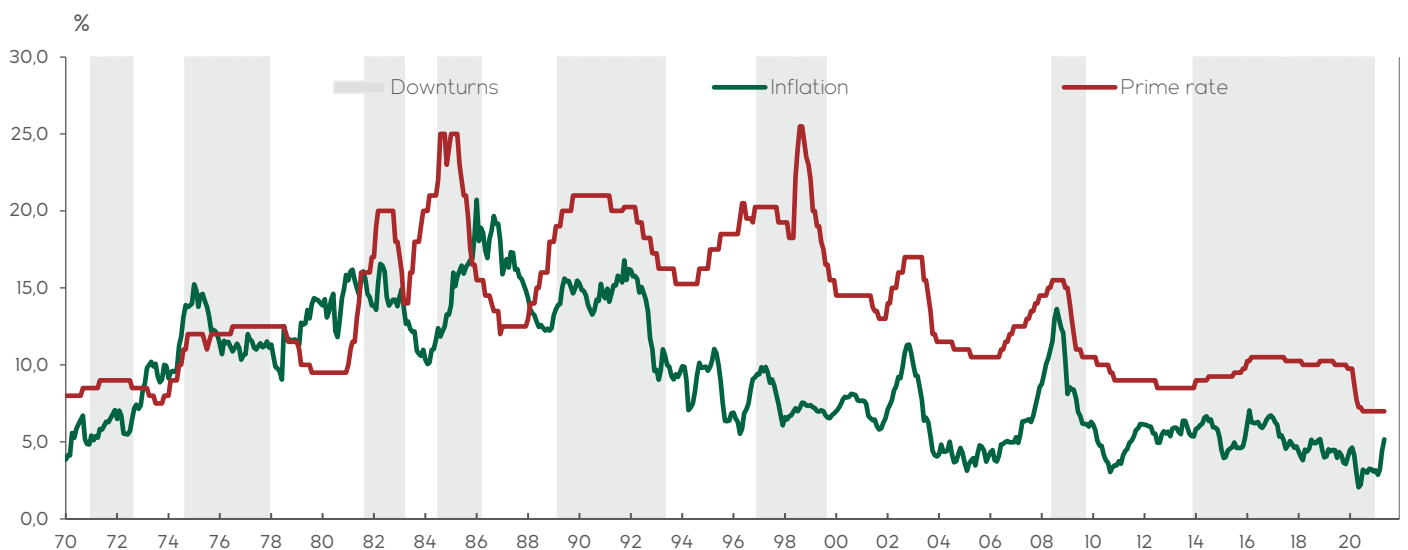


Source: Statistics South Africa

Consumer inflation increased to a 30-month high of 5.2% in May, after receding to an over 52-year low of 2.1% in May last year. The low base, therefore, greatly amplified the rise in inflation. Apart from the statistical distortions, most of the upward pressure came from imported inflation, aggravated by global supply shortages. Of these, higher global oil and food prices were the most prominent. Increases in administrated prices, particularly water and electricity tariffs, also contributed. Core inflation, which excludes food, fuel and electricity prices, started creeping up, rising to 3.1% in May from a record low of 2.5% in March.

Headline inflation is forecast to moderate in the months ahead, ending the year just above the 4.5% midpoint of the Reserve Bank’s 3% to 6% inflation target range. Thereafter inflation is forecast to stabilise, hovering around 4.5% over the next two years. Rising global inflation, particularly fuel and food prices, pose upside risks, but these are likely to be offset by the considerable slack in the domestic economy. This makes it difficult for local producers, merchants, and retailers to pass cost increases onto consumers without compromising sales volumes.

Graph 14: The prime lending rate remains near a 55-year low



Source: Statistics South Africa & South African Reserve Bank

Monetary policy remains accommodative. The Reserve Bank’s Monetary Policy Committee (MPC) left the repo rate unchanged at 3.5% in March and May. The decisions were based on a benign inflation outlook anchored near the 4.5% midpoint of the Bank’s

target range, stable inflation expectations and the uneven economic recovery, which still faces a long climb to recoup the losses inflicted by last year's shutdown.

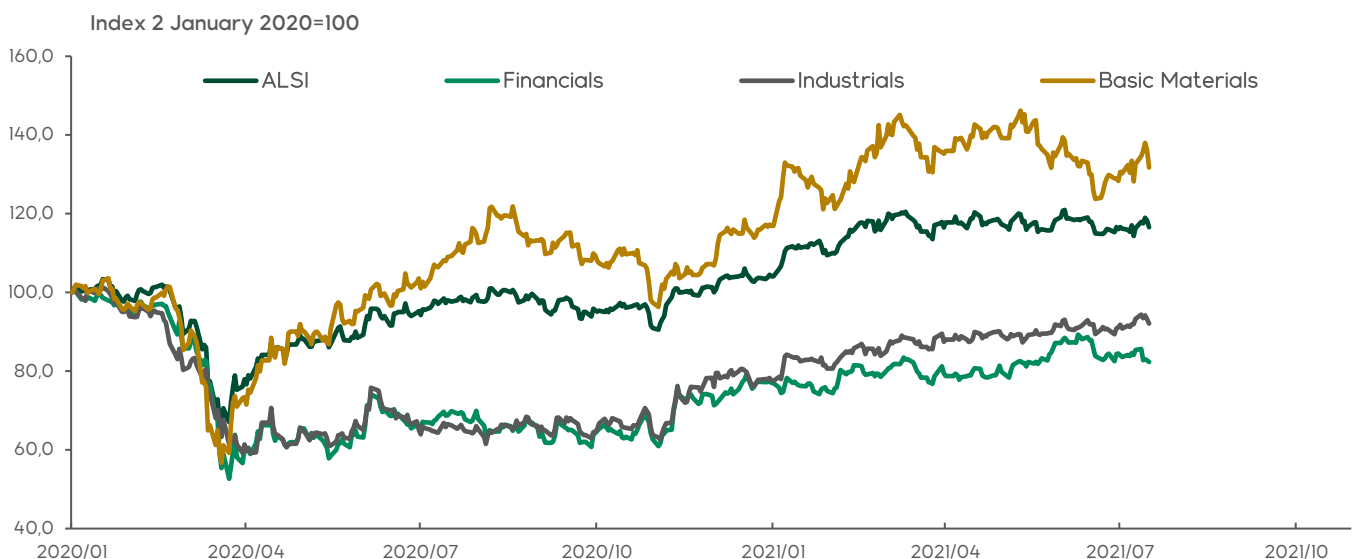
The Reserve Bank's inflation forecast was little changed, with headline inflation expected to average a slightly lower 4.2% in 2021 (from 4.3% previously), before edging up to a set of unchanged estimates of 4.4% and 4.5% in 2022 and 2023, respectively. The risks to the inflation outlook tilted to the upside, emanating from rising global oil and food prices, and higher electricity tariffs. The Bank also warned against the potential threat posed by higher domestic import tariffs and escalating wage demands. Yet the Committee felt that these upward pressures would be offset by a relative firm rand, healthy local crops, moderating unit labour costs and a subdued economic recovery. The Bank's Quarterly Projection Model (QPM) continued to recommend two hikes of 25 bps each in the second half of this year, followed by another 91 bps and 116 bps in 2022 and 2023, respectively. The Committee stressed that the 'policy stance and repurchase rate level remains highly accommodative and will remain so even with steps taken to normalise interest rate levels in response to rising inflation'.

In our view, the upside risks to the inflation outlook are roughly balanced by a slight increase in the downside risks to the growth outlook due to the prevalence of the virus, frequent lockdowns, slow vaccination rates and the destruction left by the riots. Inflation and growth fundamentals do not appear to present a compelling case for tighter monetary policy. Although US policy normalisation poses a threat to financial stability in emerging markets, we expect interest rates to remain unchanged this year. Thereafter, we forecast cumulative hikes of 100 bps in 2022, starting in January. The hiking cycle is likely to be mild by historical standards, representing a normalisation rather than a significant tightening in monetary conditions.

Local financial markets weakened in the wake of the social unrest, after tracking the gyrations on global markets over the second quarter. The violent riots, the enormous economic damage, and the images of unhindered lawlessness spooked both local and foreign investors. These events came as global risk appetites were already waning, hurt by the rapid spread of the delta variant across the globe, further evidence of rising global inflation and heightened expectations of an earlier normalisation in US monetary policy.

In the local equity market, the impact of the riots was most visible in the financial index, which shed 1.5% of its value in mid-July. However, financials were still up 7.5% since the start of the year. Elsewhere the impact was short-lived. Industrials and resources increased by a further 2.7% and 6.1% over the first two weeks of July, pushing the FTSE JSE all-share index up by 1.9% over the same period. This brought the gain over the year to date to 13.6%. Equities may be volatile as the country counts the cost of the riots, hurting share prices in the most affected sectors, but the overall index should end the year firmer due to the general recovery in company earnings from the devastation of 2020. Greater volatility is likely towards year-end in anticipation of slightly tighter global liquidity conditions.

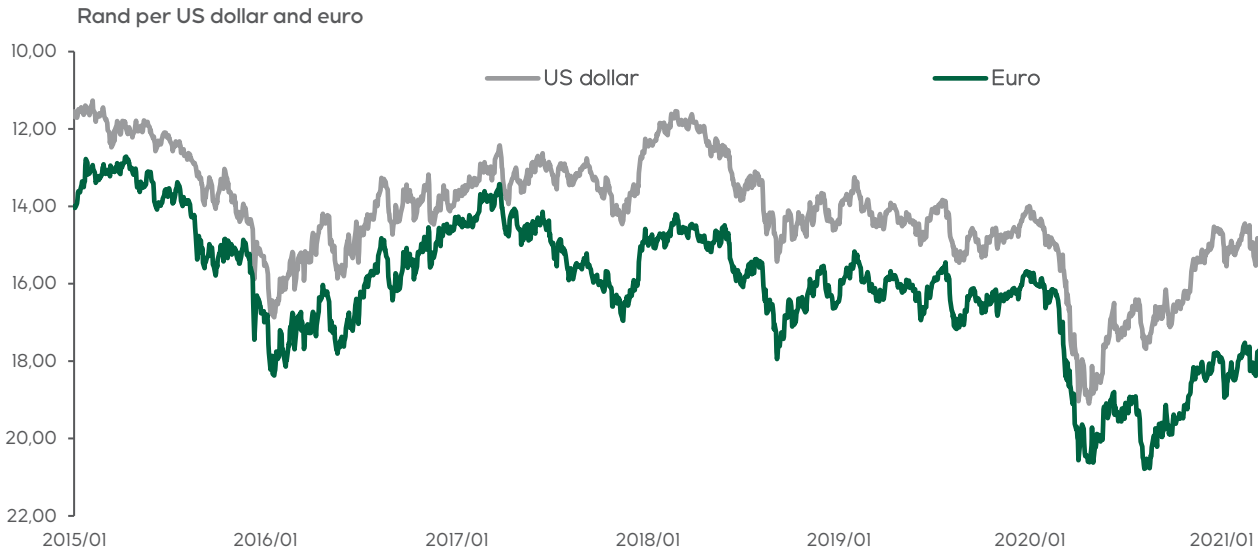
Graph 15: The recovery in equities continued



Source: Refinitiv

Bond yields also increased as the violence erupted. The yield curve also flattened marginally. Yields at the shorter end of the curve rose by more than those at the longer end. The 10-year government benchmark bond yield was still trading at 8.96% on 15 July, slightly softer than 9.06% on 31 March. While social unrest reduced foreign interest, earlier improvements in liquidity conditions and the reductions in the supply of bonds helped to contain the downside. The outlook remains murky, though. The unwinding of the US's quantitative easing programme and South Africa's stretched public finances are likely to limit further gains.

Graph 16: The rand stabilised quickly in the aftermath of the riots



Source: Refinitiv

The trade-weighted rand depreciated by 2.4% in early-July, after strengthening by 3.7% over the first half of the year. The rand is likely to trend weaker during the rest of the year, weighed down by heightened social and political risks, a clouded domestic growth outlook and volatile global risk sentiment as investors await news on the timing and speed of US policy normalisation. Some of this weakness will be countered by elevated commodity prices and positive trade flows.

Johannes Khosa

FACTS AND FORECASTS OF KEY ECONOMIC VARIABLES

Updated 17 July 2021

	2017	2018	2019	2020	2021	2022	2023
Growth (real, % change)							
GDP	1.4	0.8	0.2	-7.0	4.2	2.0	1.6
GDE	1.9	0.9	0.6	-9.0	5.3	2.4	1.5
HCE	2.1	1.8	1.0	-5.4	5.3	1.6	1.5
GDFI	1.0	-1.4	-0.9	-17.5	-2.0	1.2	2.7
Exports	-0.7	2.6	-2.5	-10.3	9.4	4.3	2.8
Imports	1.0	3.3	-0.5	-16.6	13.3	5.7	2.2
Balance of payments (Rbn)							
Exports	1168.5	1247.2	1303.1	1394.3	1750.2	1849.0	1916.4
Imports	1103.6	1222.9	1263.8	1109.5	1483.6	1653.3	1752.8
Trade balance	64.9	24.3	39.3	284.9	266.5	195.7	163.6
Net services	-183.2	-197.2	-192.5	-176.7	-199.8	-217.2	-226.0
Current account	-118.2	-173.0	-153.2	108.2	66.7	-21.5	-62.3
Financial account ¹	143.5	184.1	178.3	-162.6	131.0	134.5	140.9
Change net reserves	25.5	11.3	25.4	-54.4	197.7	113.0	78.6
Current account as a % of GDP	-2.5	-3.5	-3.0	2.2	1.2	-0.4	-1.0
Gold price (average per ounce)							
Dollar	1257.7	1268.9	1404.4	1783.4	1775.1	1722.4	1725.4
Rand	16753.9	16809.2	20330.2	29345.1	26088.4	26226.0	27673.0
Exchange rates							
Dollar-rand	13.26	13.24	14.48	16.45	14.70	15.23	16.04
Euro-dollar	1.136	1.180	1.120	1.148	1.192	1.187	1.159
Dollar-yen	111.99	110.30	109.00	106.23	110.23	111.61	114.23
British pound-dollar	1.298	1.331	1.278	1.288	1.384	1.397	1.380
Euro-rand	15.06	15.59	16.20	18.86	17.52	18.08	18.59
Rand-yen	8.46	8.38	7.54	6.49	7.51	7.33	7.12
GBP-rand	17.21	17.58	18.49	21.15	20.34	21.27	22.13
Interest rates (end of period)							
Three-month JIBAR	7.20	7.23	6.88	3.64	3.92	4.68	4.69
Prime	10.25	10.25	10.00	7.00	7.00	8.00	8.00
Long bond	8.82	9.22	8.96	8.93	8.65	8.20	7.79
Inflation (average)							
CPI	5.3	4.6	4.1	3.3	4.4	4.5	4.4

FACTS AND FORECASTS OF KEY ECONOMIC VARIABLES

Updated 17 July 2021

	2019				2020				2021			
	Q1'19	Q2'19	Q3'19	Q4'19	Q1'20	Q2'20	Q3'20	Q4'20	Q1'21	Q2'21	Q3'21	Q4'21
GDP (q-o-q annual %)	-3.18	3.31	-0.84	-1.44	-1.75	-51.68	67.30	5.85	4.62	3.79	-1.89	2.54
Interest rates												
Three-month JIBAR	7.15	7.03	6.79	6.80	5.61	3.90	3.35	3.63	3.66	3.67	3.67	3.92
Prime	10.25	10.25	10.00	10.00	8.75	7.25	7.00	7.00	7.00	7.00	7.00	7.25
Long bond (10 yr)	8.99	8.68	8.90	8.96	10.82	9.28	9.50	8.93	9.72	9.23	8.68	8.65
Inflation (end of period)												
CPI	4.52	4.46	4.13	4.02	4.14	2.22	3.00	3.08	3.20	4.88	4.56	4.72
Exchange rates												
Dollar-rand	14.59	14.15	15.19	14.13	18.03	17.31	16.98	14.64	14.94	14.27	14.43	14.69
Euro-dollar	1.12	1.14	1.09	1.12	1.10	1.12	1.17	1.23	1.17	1.19	1.18	1.18
Dollar-yen	110.60	107.74	107.85	108.67	108.38	107.66	105.58	103.15	110.72	110.53	111.86	113.09
British pound-dollar	1.31	1.27	1.23	1.31	1.23	1.23	1.28	1.36	1.38	1.38	1.38	1.38
Euro-rand	16.40	16.10	16.62	15.84	19.84	19.42	19.92	18.00	17.52	16.99	17.04	17.29
Rand-yen	7.58	7.61	7.10	7.69	6.01	6.22	6.22	7.05	7.41	7.75	7.75	7.70
GBP-rand	19.08	17.93	18.68	18.53	22.20	21.26	21.80	19.95	20.541	19.74	19.90	20.22
Gold price per ounce												
\$	1288	1412	1491	1524	1617	1772	1889	1887	1686	1759	1750	1775
Rand	18779	19976	22644	21525	29153	30688	33543	27626	25187	25099	25249	26063

Note 1: Financial account excludes reserves and includes unrecorded transactions

While every care is taken to ensure the accuracy of the information and views contained in this document, no responsibility can be assumed for any action based thereon.

GROUP ECONOMIC UNIT

Isaac Matshego
+27 10 234 8358
isaacmat@nedbank.co.za

Johannes Khoza
+27 10 234 8359
johanneskh@nedbank.co.za

Nicky Weimar
+27 10 234 8357
nickywe@nedbank.co.za

135 Rivonia Road Campus
135 Rivonia Road Sandton 2196 South Africa

nedbankgroup.co.za

