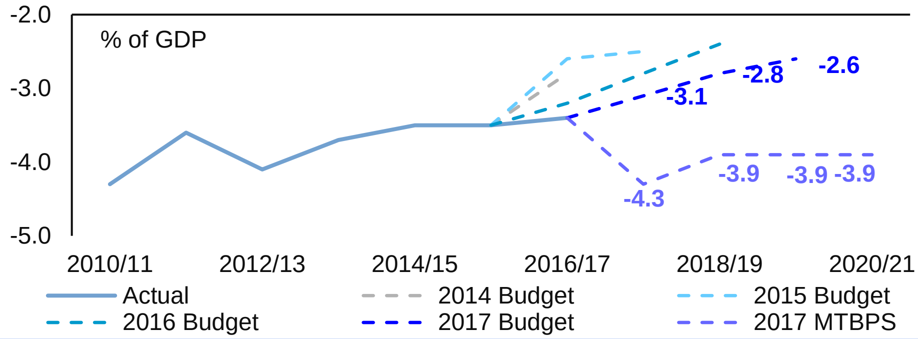
Investec

Budget Preview: 2018 Budget must reinstate commitment to fiscal consolidation to avoid further credit rating downgrades

16th February 2018

Figure 1: Consolidated budget deficit actuals and National Treasury forecasts



Source: 2017 MTBPS National Treasury

- The 2017 Medium Term Budget Policy Statement (MTBPS) outlined that in the absence of a fiscal adjustment package, the consolidated budget deficit would rise to 4.3% of GDP in 2017/18 from 3.4% in 2016/17 and would remain at 3.9% over the medium term framework period of 2018/19 to 2020/21.

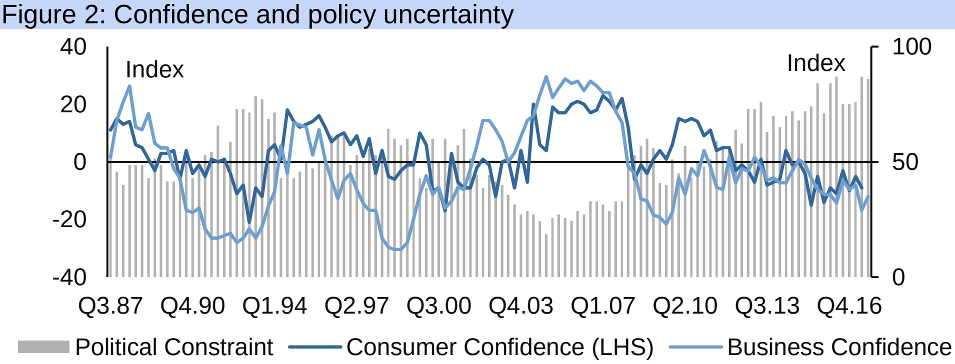
- The postponement of fiscal consolidation in the MTBPS, and the absence of a stabilisation of debt ratios, was viewed as credit negative by the rating agencies.

- To avoid further credit rating downgrades, the 2018 Budget will need to implement material revenue and, particularly, expenditure side adjustments to achieve fiscal consolidation over the medium-term. A degree of fiscal consolidation was already expected to be presented in the 2018 Budget based on a statement from the National Treasury in November 2017 that "(t)he 2018 Budget will outline decisive and specific policy measures to strengthen the fiscal framework".

- We project the revenue and expenditure side measures, along with slower CPI inflation and slightly higher nominal GDP growth, will yield a consolidated budget deficit of 4.0% of GDP in 2018/19. The deficit is then forecast to compress to 3.4% of GDP in 2019/20 and 2020/21 on fiscal consolidation.

- The tightening of fiscal levers (adjustments to revenue and expenditure projections) is a key component of rebuilding confidence and avoiding further credit rating downgrades. Beyond this, the 2018 Budget will need to elaborate on the other "short-term confidence-boosting measures" outlined in the 2017 MTBPS. These include further detail on managing "fiscal and economic risks associated with state-owned entities"; and creating "policy certainty by finalising key legislative and policy processes".

Figure 2: Confidence and policy uncertainty



Source: BER

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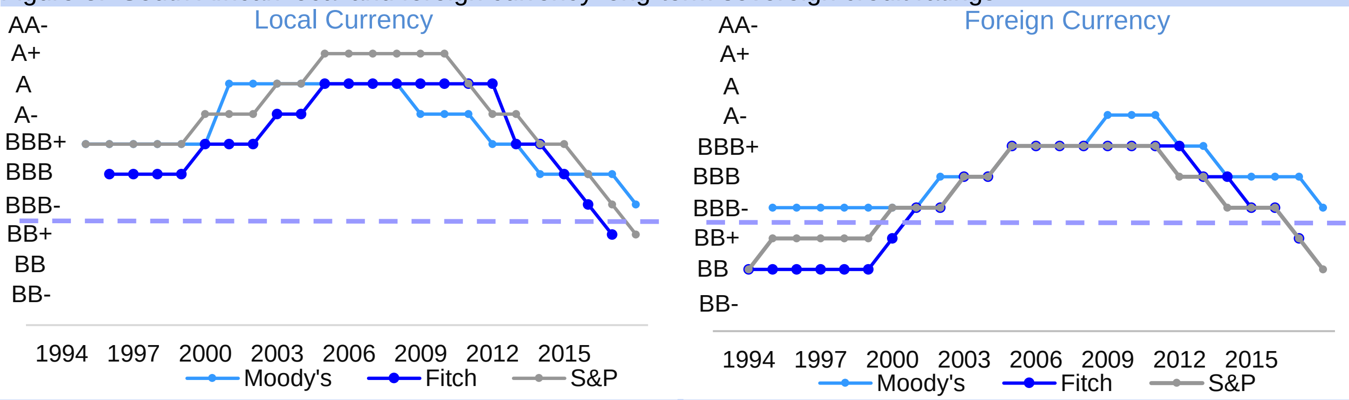
Figure 3: South African local and foreign currency long-term sovereign credit ratings



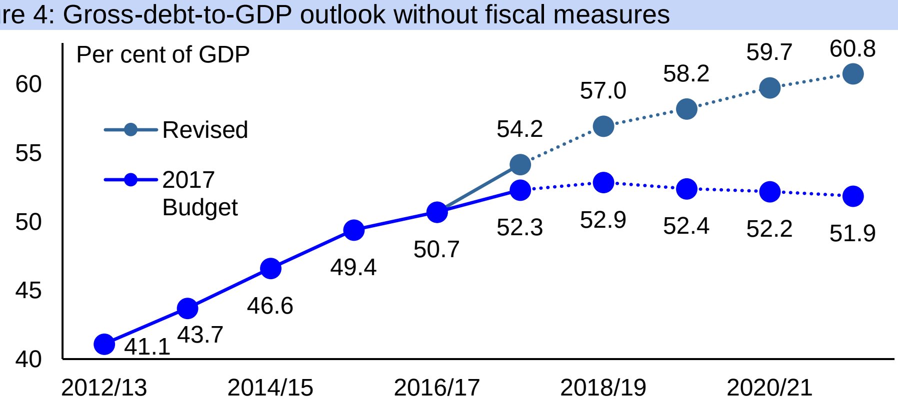
Sources: Rating Agencies

The 2017 Medium Term Budget Policy Statement (MTBPS) outlined that in the absence of a fiscal adjustment package, the consolidated budget deficit would rise to 4.3% of GDP in 2017/18 from 3.4% in 2016/17 and would remain at 3.9% over the medium term framework period of 2018/19 to 2020/21 (see figure 1). Gross and net loan debt were seen rising throughout the medium-term framework period to 59.7% and 55.6% respectively in 2020/21 (see figure 4). Previously, gross debt was estimated to stabilise at 53% of GDP in 2018/19 and recede thereafter with net debt peaking at 48.2% in 2020/21.

The postponement of fiscal consolidation in the MTBPS, and the absence of a stabilisation of debt ratios, was viewed as credit negative by the rating agencies. Post the MTBPS, Fitch affirmed SA's non-investment grade credit rating whilst S&P downgraded SA's local currency rating to one notch below investment grade and the foreign currency rating to two notches below investment grade. SA's credit rating with Moody's, which is presently one notch above non-investment grade, was placed on review for a downgrade (see figure 3). Moody's noted that this review would assess the "size and the composition of the 2018 budget."

Specifically, the 2018 Budget would need to implement material revenue and, particularly, expenditure side adjustments to achieve fiscal consolidation over the medium-term. A degree of fiscal consolidation was already expected to be presented in the 2018 Budget based on a statement from the National Treasury in November 2017 that "(t)he 2018 Budget will outline decisive and specific policy measures to strengthen the fiscal framework".

Figure 4: Gross-debt-to-GDP outlook without fiscal measures



Source: 2017 MTBPS National Treasury

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Figure 5: Announced consolidation measures, 2017/18-2018/19

	2017/18	2018/19
2016 Budget		
Expenditure reductions	10	15
Revenue increases	15	15
2017 Budget		
Expenditure reductions	10	16
Revenue increases	13	-
Total		
Expenditure reductions	20	31
Revenue increases	28	15

Source: 2017 Budget National Treasury, Investec

The statement further outlined that "(i)n the MTBPS…we indicated that additional spending cuts or tax increases of R40 billion (0.8 per cent of GDP), would be required from 2018/19, in order to stabilise public debt below 60 per cent of GDP over the next decade." A "package of measures to this effect" will be outlined in the 2018 Budget.

This R40bn fiscal adjustment would be in addition to the consolidation measures previously announced in the 2016 and 2017 Budgets (see figure 5). These include expenditure cuts of R31bn and revenue increases of R15bn, with the full adjustment therefore totaling R46bn. The composition and magnitude of adjustments are likely to be informed by the presidential task team and the Davis Tax Committee (DTC).

On the revenue side, the 2017 MTBPS confirmed a substantial shortfall, of an estimated R50.8bn in 2017/18 and an additional shortfall of a combined R158.7bn in 2018/19 and 2019/20 (see figure 6). The revenue under-collection has been apparent across all of the major tax categories and linked to weak economic growth and diminished tax buoyancy (see figure 7). The additional revenue will likely be raised through a combination of tax adjustments, other than increases in personal and corporate tax rates.

Personal income tax collections have been affected by high unemployment and slower growth in employee compensation. These factors, along with depressed consumer confidence and weak rates of credit

Figure 6: Gross tax revenue

	2016/17			2017/18		
R billion	**Budget[1]**	**Outcome**	**Deviations**	**Budget[1]**	**Revised**	**Deviations**
Persons and individuals	425.8	424.5	-1.3	482.1	461.3	-20.8
Companies	205.1	204.4	-0.7	218.7	213.9	-4.8
Value-added tax	290.0	289.2	-0.8	312.8	301.3	-11.4
Dividend withholding tax[2]	25.7	31.1	5.4	34.2	31.6	-2.6
Specific excise duties	35.7	35.8	0.1	39.9	37.4	-2.5
Fuel levy	63.0	62.8	-0.2	70.9	70.1	-0.8
Customs duties	47.5	45.6	-1.9	52.6	47.2	-5.4
Ad-valorem excise duties	3.4	3.4	0.0	3.6	3.6	-0.0
Other	48.2	47.3	-0.9	50.7	48.4	-2.3
Gross tax revenue	**1 144.4**	**1 144.1**	**-0.3**	**1 265.5**	**1 214.7**	**-50.8**

Source: 2017 MTBPS National Treasury

1. 2017 Budget figures

2. Includes secondary tax on companies

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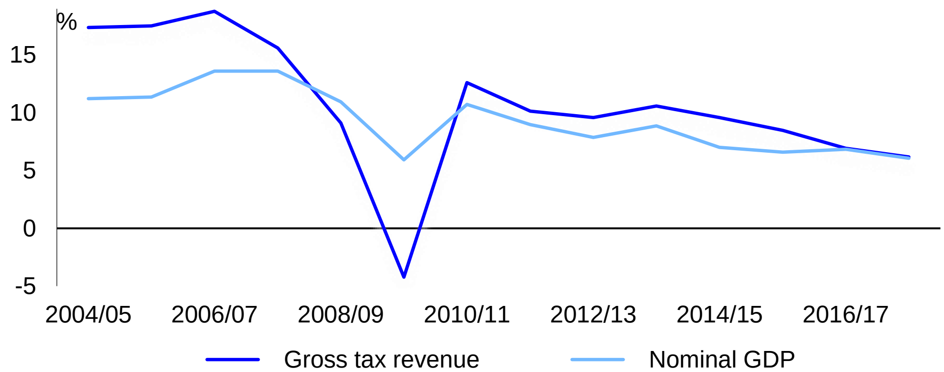
Figure 7: Growth in gross tax revenue and nominal GDP



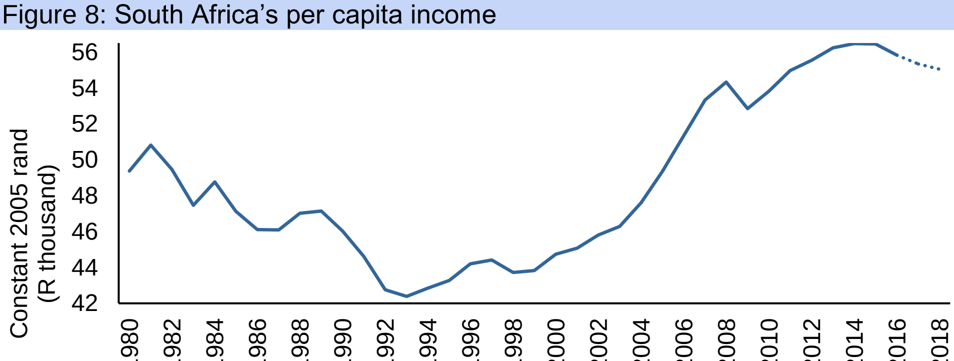
Source: 2017 MTBPS National Treasury

extension have also restrained household consumption expenditure which is the tax base for VAT receipts. Another contributing factor to the lower collections relates to "(c)ompliance concerns [that] are mounting in the context of tax administration challenges and weakening tax morality."

The 2017 MTBPS cautioned that "(g)iven that per capita income is falling, the economic impact of further… tax hikes could be counter-productive" (see figure 8). This would suggest a reluctance to hike personal income tax rates. Although an increase in the marginal income tax rates at the high end cannot be completely precluded, the OECD has previously cautioned that "relatively few individuals face the top marginal tax and so increasing the top rate alone would yield relatively little revenue". Large increases in the top rate could have "detrimental effects on skill accumulation, entrepreneurial activity and immigration of high-skilled workers."

Corporate income tax rates are also likely to remain unchanged. The OECD assessed that the corporate tax burden is relatively high by international comparison (see figure 9). Given the relatively modest economic growth climate, raising corporate taxes at this juncture would weaken the prospects for a recovery in private sector employment levels and fixed investment rates. However, efforts to address base erosion and profit shifting are likely to continue being strengthened, in a bid to broaden the corporate tax base.

Figure 8: South Africa's per capita income



Source: Reserve Bank, National Treasury

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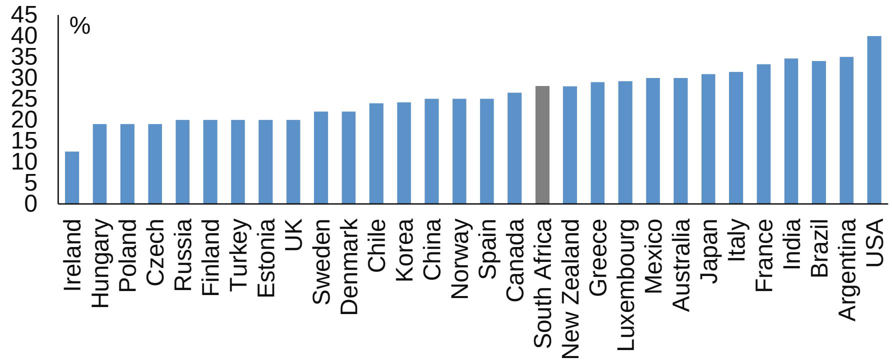
Figure 9: Corporate tax rates



Source: KPMG, National Treasury

With the 2017 MTBPS not indicating a potential increase in personal or corporate tax rates, it can be inferred that the additional revenue is likely to be raised via the bracket creep adjustment, indirect taxes and within the wealth tax spectrum.

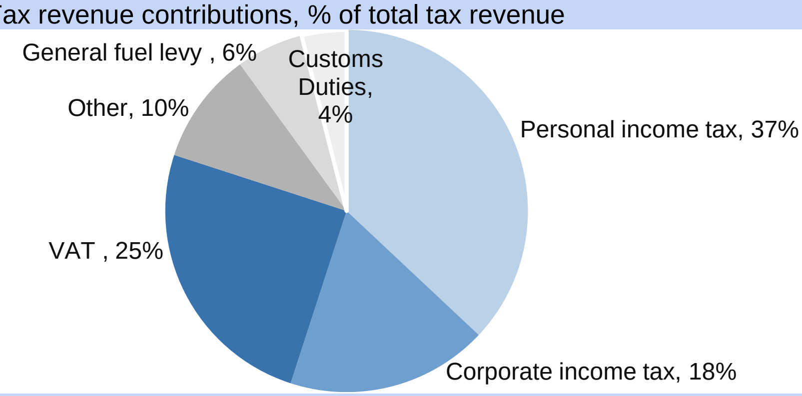
As such, personal income tax brackets and thresholds are likely to be increased well below expected inflation. This will translate to limited, or no, fiscal drag relief and essentially an increase in the real effective personal income tax rate.

The 2017 Budget noted that given the limited scope to continue raising the personal income tax burden "it may be necessary to adjust consumption taxes. The least economically damaging means of doing so would be to increase the VAT rate".

This funding strategy would be consistent with the DTC's assessment that in terms of longer term implications for the economy, an increase in the VAT rate would be less damaging compared to increases in personal or corporate income taxes. Specifically, the Committee found that raising R45bn in tax revenues could be derived from a 3.0% increase in the VAT rate or a 6.1% increase in personal income tax rates or a 5.2% increase in corporate income tax.

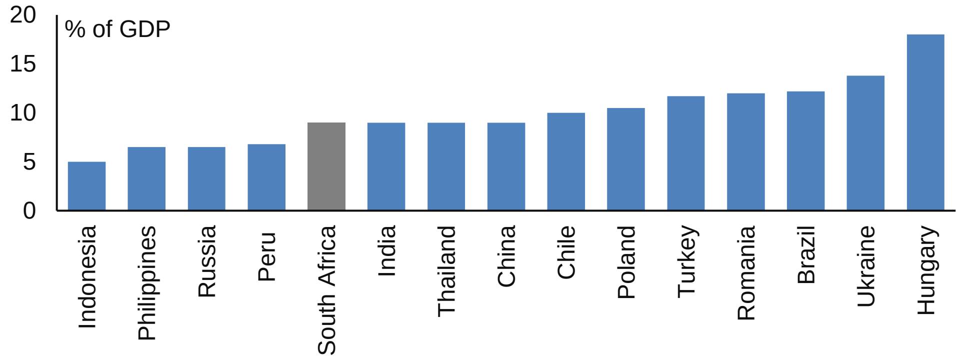
Although a VAT rate hike in the forthcoming Budget cannot be completely precluded but is not expected ahead of the 2019 elections. Moreover, the proceeds of a VAT rate hike are expected to be earmarked for

Figure 10: Tax revenue contributions, % of total tax revenue



Source: National Treasury, Investec

Figure 11: Consumption taxes



Source: National Treasury

the funding strategy for government reform programmes such as the National Health Insurance.

It is therefore expected that tax adjustments in the 2018 Budget will be concentrated in the other indirect tax category. Specifically, excise taxes on alcohol and tobacco are likely to continue increasing at an above inflation rate, as has been the case since 2002.

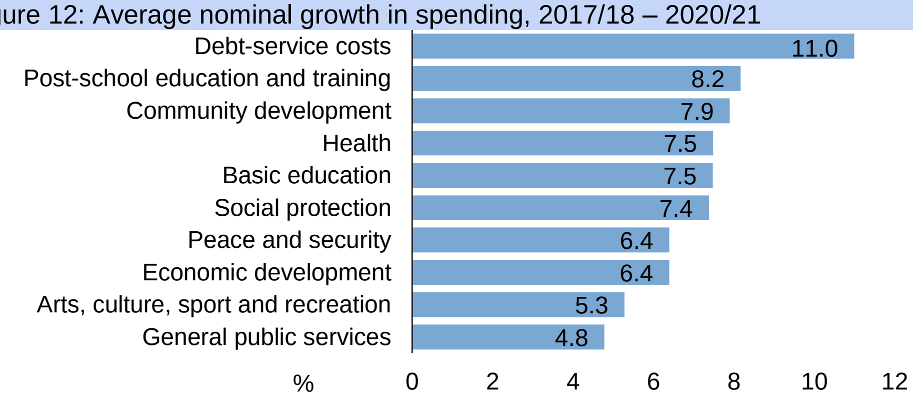
Further increases are likely in the environmental tax spectrum that includes fuel taxes and levies on tyres, incandescent globes, plastic bags and vehicle emissions. The 2018 Budget could also implement last year's proposal to remove the zero-rating on fuel.

The Budget will confirm the implementation of the tax on sugar-sweetened beverages from 1 April 2018.

Changes to the Estate Duty rate are also possible. The DTC has previously recommended increasing the rate from 20% to 25% of the dutiable value of an estate exceeding R30 million. Moreover, inter-spouse abatement is recommended to be withdrawn regarding estate duty, capital gains tax and donations tax.

The DTC has also recommended further increases in the capital gains tax inclusion rates for corporates and an increase in the skills development levy. This source of tax revenue would be earmarked for the funding of tertiary education.

Figure 12: Average nominal growth in spending, 2017/18 – 2020/21



Source: National Treasury

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Figure 13: Main budget expenditure ceiling[1]

R billion/percentage change	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
2015 Budget Review	1 006 905	1 081 214	1 152 833	1 250 086			
2016 Budget Review	1 001 874	1 076 705	1 152 833	1 240 086	1 339 422		
2016 MTBPS		1 074 992	1 144 353	1 229 742	1 323 465	1 435 314	
2017 Budget Review[2]		1 074 970	1 144 225	1 229 823	1 323 553	1 435 408	
2017 MTBPS		**1 074 970**	**1 141 978**	**1 233 722**	**1 316 553**	**1 420 408**	**1 524 222**

Source: National Treasury

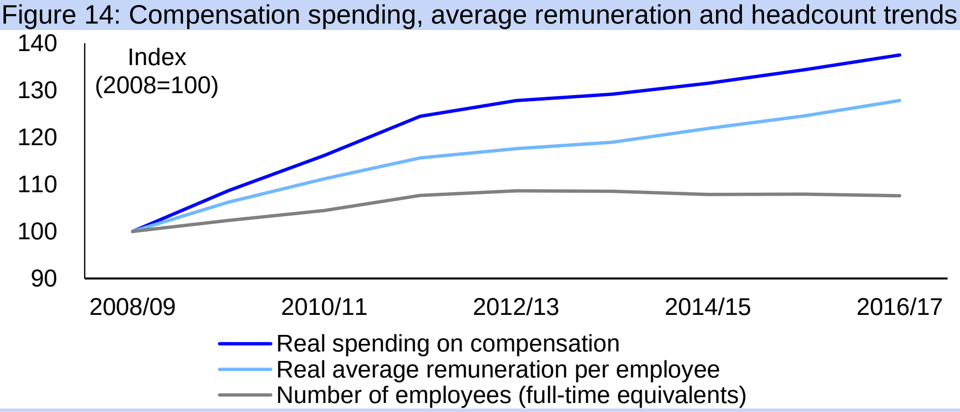
1. *The expenditure ceiling differs from main budget non-interest expenditure. The precise definition and calculation of the expenditure ceiling is contained in Annexure C*
2. *Adjusted for the full amount for New Development Bank in 2015/16 and for the International Oil Pollution Compensation Fund.*

National Treasury confirmed in December 2017 that it was "in the process of reviewing the details of the higher education proposals, as well as possible financing options", with related announcements to be made in the 2018 Budget. The DTC outlined that R30bn per year would be needed to fund tuition but calculates that if accommodation and other living expenses are included, the amount rises to R60bn. Tertiary education is already the second fastest growing expenditure item and the 2017 MTBPS acknowledged that to accommodate new policy initiatives, spending would have to be reprioritised and any "resulting adjustments to the spending ceiling, will need to be matched by parallel tax increases" (see figure 12). However, given the limited scope for significant tax increases, it is likely that any tertiary funding strategy would be implemented in stages such that the expenditure ceiling is not breached.

The 2018 Budget will have to signal an adherence to the nominal expenditure ceiling and ideally, intentions to further reduce the ceiling over the medium-term (see figure 13). The main measures taken to contain spending within the expenditure ceiling will likely continue to include the reprioritsation of expenditure; cost containment measures on non-essential goods and services; procurement reforms and limits on compensation.

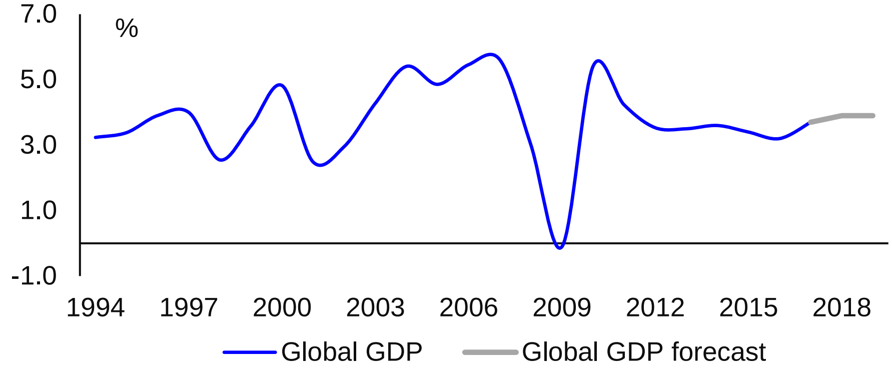
Rising compensation, resulting from the combination of expanded headcounts and higher remuneration, has been the key pressure point on the fiscus (see figure 14). The wage bill comprises the largest share of current expenditure, at 35.3% in 2016/17. Since 2008/09, compensation of employees has increased at an average rate of 10.3% per year, outpacing average nominal GDP growth of 7.9% and has not been matched by "a commensurate increase in productivity" according to the 2016 Budget. The 2017 MTBPS allowed for average compensation expenditure growth of 7.3% over the medium term. The outcome of the 2017/18

Figure 14: Compensation spending, average remuneration and headcount trends



Source: 2017 MTBPS National Treasury

Figure 15: Global GDP actual and forecasts



Source: IMF

wage negotiations poses a potential risk if the settlement occurs in excess of the MTBPS estimate. Wage bill pressures could threaten the expenditure ceiling and/or the composition of government spending.

We project the revenue and expenditure side measures, along with slower CPI inflation and slightly higher nominal GDP growth, will yield a consolidated budget deficit of 4.0% of GDP in 2018/19. The deficit is then forecast to compress to 3.4% of GDP in 2019/20 and 2020/21 if fiscal consolidation is indeed undertaken.

Compared with the 2017 MTBPS, nominal GDP growth forecasts are likely to be revised slightly higher on the expected improvement in domestic consumer and business sentiment, in view of the recent political developments, and the derived benefits of an increasingly synchronised global economic upturn. This would imply a slight upward revision to the nominal growth in gross tax revenue. National Treasury is also likely to factor in the improved CPI inflation outlook linked to exchange rate appreciation.

In the meantime, for the 2017/18 fiscal year, the 2018 Budget should broadly confirm the revenue and expenditure outcomes outlined in the MTBPS. In particular, the MTBPS estimated a tax revenue shortfall of R50.8bn. Inferring from the government finance data available to date, this estimate remains valid. Specifically, in the first nine months of the 2017/18 fiscal year (April 2017 to December 2017), government tax revenue rose by 6.2% y/y versus the 2017 Budget estimate of 10.6% y/y growth for the full year. Applying this year to date growth rate to the prior fiscal year's tax revenue yields a gross tax revenue shortfall of R50.5bn. Employing the same method to overall main budget revenue reflects a shortfall of R47.4bn, to R1 195bn, relative to 2017 Budget estimates.

Expenditures rose 8.0% y/y in the first nine months of the fiscal year, exceeding the 2017 Budget estimate of 7.9% y/y growth for the full fiscal year. Projections based on this year to date expenditure growth suggest overspending of R3.9bn, which is mainly attributable to a breach of the expenditure ceiling, owing to the

Figure 16: National revenue and expenditure: R thousand unless otherwise stated

	Dec 2017	Fiscal year to date	2017/18 budget revised	% of budget	2016/17: % budget
Revenue:	157 433	856 101	1 161 996	71.7	71.6
Expenditure:	144 251	1 037 995	1 318 338	73.5	73.6
Deficit:	13 182	-181 894	--219.6	82.8	87.3

Source: National Treasury

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Figure 17: Revisions to the 2017/18 expenditure ceiling

	R million
Expenditure ceiling: 2017 Budget Review	**1 229 823**
Upward expenditure adjustments	**16 167**
Roll-over of funds from 2016/17	217
Unforeseeable and unavoidable expenditure	586
Section 16 of the PFMA (SAA recapitalisation)	5 208
Announced in the 2017 Budget[1]	8 609
Self-financing[2]	1 547
Downward expenditure adjustments	**(12 268)**
Declared unspent funds	(1 668)
Direct charges against the National Revenue Fund: Magistrates' salaries	(100)
Contingency reserve	(6 000)
National government projected underspending	(3 000)
Local government repayment to the National Revenue Fund	(1 500)
Revised expenditure ceiling	**1 233 722**

Source: National Treasury

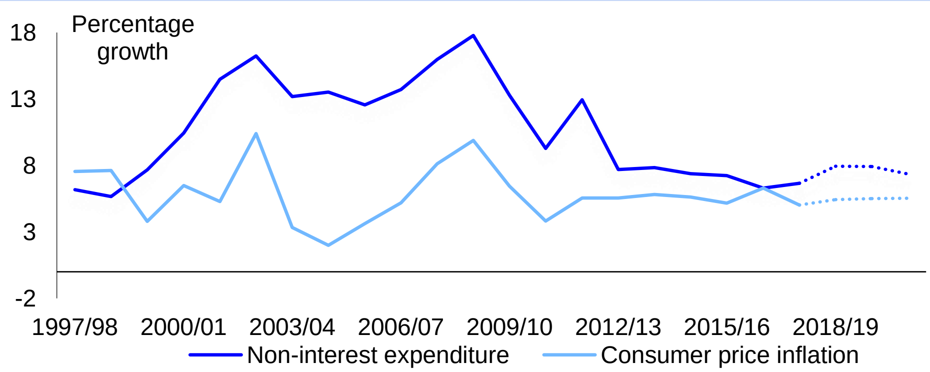
1. Includes the recapitalisation of the SAPO (R3.7 billion) and SAA (R4.8 billion) and the finalisation of the establishment of the Tirisano Construction Fund Trust (R117 million) *2. Spending financed from revenue derived from a vote's specific activities*

government bailouts of South African Airways (SAA) and the South African Post Office (SAPO). The combined allocation to SAA and SAPO totaled R13.7bn. However, this amount is partially offset by a projected underspending in the current fiscal year and a drawdown of the contingency reserve which adjusts the effect of the bailouts on expenditure to R3.9bn (see figure 17).

The MTBPS noted that "the disposal of assets to offset these appropriation" is being considered. The Minister's speech made reference to the decision to dispose of a portion of government's Telkom shares. The 2018 Budget will confirm whether the asset sales transpired and the breach was reversed to maintain the expenditure ceiling.

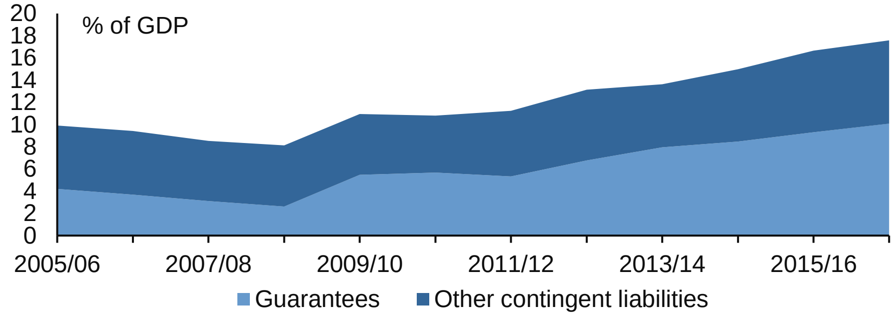
The revenue and expenditure side estimates outlined above would yield a *main* budget deficit of R218bn which translates to a deficit of 4.6% of GDP versus the -4.7% MTBPS estimate. The consolidated budget comprises the main budget deficit which is typically partially offset by a combined cash surplus from social security funds and public entities financed from their own revenue. Factoring in these flows yields a *consolidated* budget deficit estimate of -4.3% of GDP, in line with MTBPS projection.

Figure 18: Growth in main budget expenditure and consumer inflation



Source: 2017 MTBPS National Treasury

Figure 19: Contingent liabilities



Source: National Treasury

The tightening of fiscal levers (adjustments to revenue and expenditure projections) is a key component of rebuilding confidence and avoiding further credit rating downgrades. Beyond this, the 2018 Budget will need to elaborate on the other "short-term confidence-boosting measures" outlined in the 2017 MTBPS. These include further detail on managing "fiscal and economic risks associated with state-owned entities"; and creating "policy certainty by finalising key legislative and policy processes".

In particular, sizeable fiscal risks are associated with the realisation of contingent liabilities and/or the recapitalisation of state-owned enterprises (SOEs). Government's major contingent liabilities relate to its guarantees. Government contingent liabilities have risen since 2008/09, reflecting the deterioration in the balance sheet position of several SOEs and the absence of structural reform in governance and management of SOEs (see figure 19). Specifically, guarantees to public institutions have risen from R298.4bn in 2009/10 to R477.7bn in 2016/17 (see figure 20). Over the same period, exposure (the amount that SOEs have borrowed against the guarantees) increased from R129.1bn to R308.3bn. The realisation of these contingent liabilities could push government debt levels from 54% of GDP to 70% (see figure 21).

Figure 20: Government guarantee exposure

	2009/10		**2016/17**	
R billion	Guarantee	Exposure	Guarantee	Exposure
State-owned companies	**298.4**	**129.1**	**477.7**	**308.3**
of which:				
Eskom	*176.0*	*46.7*	*350.0*	*218.2*
SANRAL	*38.9*	*12.3*	*38.9*	*30.1*
Trans-Caledon Tunnel Authority	*25.6*	*20.7*	*25.7*	*20.7*
South African Airways	*1.6*	*1.4*	*19.1*	*17.9*
Land Bank	*3.8*	*2.6*	*11.1*	*5.4*
Development Bank	*29.3*	*26.6*	*12.7*	*4.2*
South African Post Office	-	-	*4.4*	*3.9*
Transnet	*11.4*	*11.6*	*3.5*	*3.8*
Denel	*1.9*	*1.9*	*1.9*	*1.9*
South African Express	-	-	*1.1*	*1.0*
Industrial Development Corporation	*1.6*	*0.9*	*1.9*	*0.2*
South African Reserve Bank	*7.0*	-	*3.0*	–
Independent power producers	**-**	**-**	**200.2**	**125.8**
Public-private partnerships	**-**	**-**	**10.9**	**10.9**

Source: National Treasury

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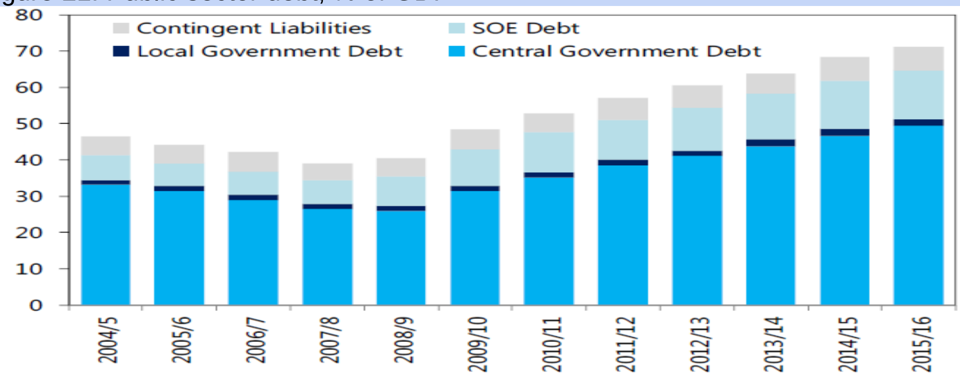
Figure 21: Public sector debt, % of GDP



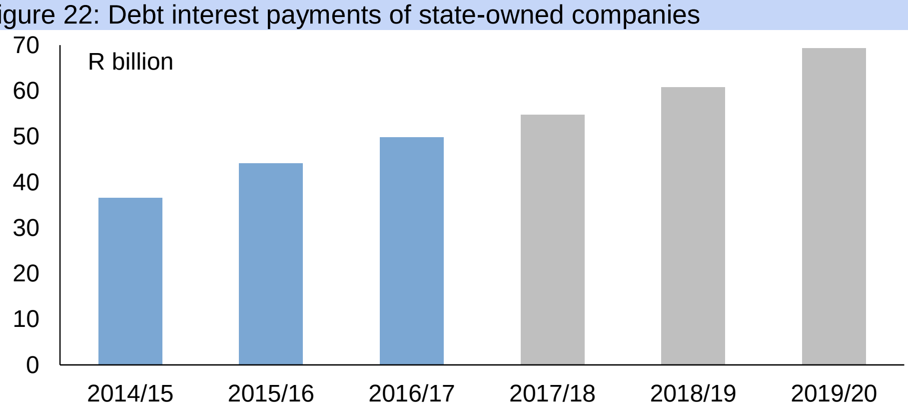
Source: IMF

Aside from the appropriations to SAA and SAPO in the 2017/18 fiscal year, the MTBPS noted that Denel, South African Express and the South African Broadcasting Corporation are likely to require capital injections. However, the amounts are likely to be comparatively small with Eskom the more prominent risk. Eskom has used up two-thirds of the R350bn guarantees and continues to grapple with liquidity shortages.

It is encouraging that new boards have been instated at Eskom and SAA and that government is developing a "new framework for the management of guarantees" rendering it more stringent. However, the concerns surrounding rising SOE debt still need to be addressed.

The 2017 MTBPS highlighted that faster and sustained economic growth is vital to improving the fiscal outlook and recommended the "(r)apid implementation" of measures aligned with the National Development Plan (NDP). In the absence a sustained economic growth recovery to 3.0% and beyond, accomplishing fiscal consolidation will be difficult. Effective policy implementation and the enhancement of policy certainty are required to restore business confidence and enhance the investment climate which would ultimately lift potential GDP growth.

Figure 22: Debt interest payments of state-owned companies



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Kamilla Kaplan • Investec Bank Limited • Tel (2711) 286 7747 • email: kamilla.kaplan@investec.co.za •
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