South Africa

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High political and policy uncertainty has weighed on economic activity leading to sub-par GDP growth. Despite an expected cyclical upswing in 2017, the relatively low growth environment is making it increasingly challenging to rein in a rising government debt. Political infighting is also taking attention away from implementing structural reforms to improve medium-term growth.

Country Risk Analysis

Summary

Growth in the South African economy has decelerated markedly since 2011 which clearly contrasts to developments in regional peers and its main trading partners. Many observers have noted that this decoupling is not merely of a cyclical character. Although the weak commodity price cycle has been important, and although a severe drought has weighed on economic activity, the slowdown mainly reflects political and policy uncertainty. Infighting within the ruling ANC party has led to an environment where businesses and households are reluctant to invest and spend. In addition, and perhaps more importantly, the infighting has taken the focus away from implementing structural reforms which are crucial in order to get economic growth back on a higher and more stable path.

The political uncertainty escalated recently in an extensive make-over of the cabinet of ministers, including the ousting of a much respected finance minister. We conclude that the probability of meaningful economic reforms being implemented in the near-term has declined.

Meanwhile, fiscal policy, which is governed by a sound framework, is targeting a continued gradual reduction of the budget deficit. This is important as government debt is on a rising trend. Recent changes to the cabinet of ministers are putting the government's commitment to the fiscal targets in doubt.

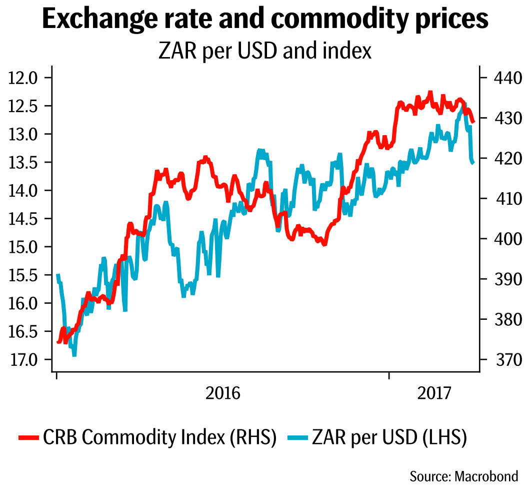
Risks are mainly related to slower economic growth and the complications this would have in reducing the public sector deficit and stabilising government debt. Slower than expected growth could be due to weaker than expected demand among trading partners or from weaknesses in global commodity prices. A more protracted period of political and policy uncertainty would also depress growth.

Recent economic developments

Economy stalling. Economic growth has been only 1.6% in the past five years, clearly lower than among rating peers and a factor that has been weighing on country risk for some time. External conditions, including weak demand among chief trading partner, low commodity prices and a drought have been part of the explanation. However domestic constraints such as political uncertainty, poorly functioning labour and product markets, inadequate power supply and badly managed state-owned enterprises also contributed to the sub-par performance. In 2016, GDP growth fell again, to 0.3% which was the slowest since the global financial crisis. With annual population growth of about 1.5%, it means that GDP per capita fell for the fifth consecutive year. 2017 has started off on a positive note indicating that the low point most likely has been reached, and a moderate recovery lies ahead.

In**flation is high but has peaked.** Inflation that started rising rapidly already in 2015 on the back of food price rises and the depreciating currency, remained elevated in 2016 at 6.3%. In early 2017 it was still above the central bank's target of 3-6% but is likely to have peaked, partly due to base effects. Meanwhile, more than a quarter of the population remains unemployed.

Exchange rate strengthened on higher commodity prices, dipped on politics. The exchange rate recovered ground in 2016 and early 2017, supported by rising commodity prices, a shrinking current account deficit and interest rate hikes. Recent political turbulence, however, has seen the rand plunge. Moreover, the more sour market sentiment has seen CDS rates and bond spreads rise.



External deficit declined. Commodities dominate South Africa's export basket and the country is a leading exporter of gold and platinum. Consequently, the recovery in global commodity prices starting in early 2016 have boosted exports while also contributing to better terms of trade. At the same time, very weak domestic demand is reflected in a contraction of imports. The resulting positive trade balance led to an improvement in the current account balances to about -3.6% of GDP in 2016. This is still fairly high compared to rating peers and reflects a structural deficit on the income account. Annual transfers to Southern Africa's Custom Union amount to about 1% of GDP.

Financing is sensitive to shifts in global risk sentiment. A significant part of the deficit is financed through portfolio flows rather than more stable investments. In addition, while foreign currency denominated debt is marginal, more than 30% of the local currency denominated government debt is held by foreigners. This naturally makes the financing of the economy vulnerable to shifts in global investor sentiment. The comparably large foreign holdings are actually the main vulnerability on the external side as external debt is moderate (around 45% of GDP) and well in line with peers in similar risk classes. Roughly one third of this debt is owed by the government and another relatively high share consists of intra-company loans.

Central bank reserves are adequate given flexible exchange rate. Moreover, central bank foreign exchange reserves have been comparably stable recently at levels equivalent to about 6 months' imports. This is adequate given the commitment to a floating exchange rate.

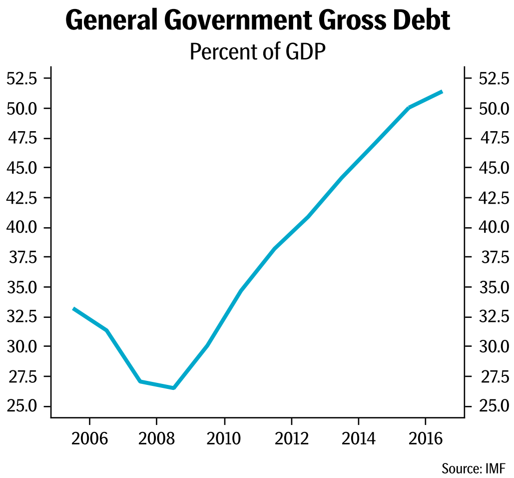
Economic policies

Poor progress on structural policies. South Africa's key challenges are not related to the economic cycle. Currently they are political. Political infighting during 2016 did not only create uncertainty for businesses and households but it also delayed progress on reforms necessary to restart economic growth. While a weak cyclical recovery may be in the cards, there are several long-standing supply-side constraints that will hinder any meaningful rise in economic activity. They include a poorly functioning labour and product markets, inadequate energy and transport infrastructure and an education system that is below the standards of most regional peers.

Several sound ways to deal with these and other structural bottlenecks are included in the "National Development Plan (NDP)" but implementation has been very piecemeal. While progress has been made on improving electricity supply, many would argue that recent policy steps relating to the labour market, including the introduction of a minimum wage, have actually made the situation worse.

Fiscal policies on a slow consolidation path. The country's fiscal policy framework, on the other hand, is considered robust and better than average for most similar emerging markets. The government has also built a track record in prudently managing its finances. Accordingly, the past years' gradual consolidation continued in 2016 leaving the budget balance in a deficit to the tune of 3.3% of GDP. Current budget plans envisage a further gradual reduction in the deficit in 2017 although the very low growth environment could make this challenging.

Government debt is the key fiscal weakness. Continued deficits in public finances implied a continued rise in government debt in 2016.General government debt is estimated to have risen to 51% of GDP by the end of the year (IMF definition). Low economic growth makes the government's debt burden more challenging. At the same time, the composition of the debt is relatively favourable as it is mainly domestically denominated and has a long average maturity.



Contingent liabilities on the rise.
Coming on top of the headline debt numbers are contingent liabilities to the government from the debts of large state-owned enterprises, in particular from the non-investment grade rated electricity giant Eskom. These have risen in the past few years. Consequently, we believe government debt as a share of GDP is likely to continue to climb in the near-term.

Banking sector relatively sound. Given the poor economic environment, the banking sector remains a relatively bright spot. Profitability in the sector has risen recently and capital adequacy has improved. The share of non-performing loans has continued down although signs are that the ratio has bottomed.

Political and policy uncertainty has risen further. Political risk rose in 2016 as divisions within the governing ANC party deepened. The split in the party runs along several lines, including urban and rural factions and along traditional and modern views. Wider dissatisfaction with the government's policies helped the opposition make historical gains in the 2016 municipal elections. The ANC tensions recently escalated when President Zuma unexpectedly made sweeping changes to his cabinet of ministers, including firing finance minister Gordhan who has been seen as the anchor of stability for the economy, standing for a prudent fiscal policy and anti-corruption.

Sudden moves in a radical policy direction are not seen as very likely in the near-term. The new finance minister has stated he intends to stick to the fiscal framework and the current budget. At the same time, risks of a more radical approach, including a deviation from the path of fiscal consolidation, have risen and this could very well materialise closer to presidential elections in 2019. President Zuma is likely to cling on to the presidential post until the elections.

Increasing policy uncertainty, in turn, likely means an extended period of reluctance of corporates to invest which may depress economic activity. Slower growth will make it increasingly challenging to meet the fiscal targets. Moreover, risks have also risen that the implementation of meaningful structural measures is delayed.

External rating agency cut sovereign rating. Standard&Poor's and Fitchratings reacted to the latest political developments and downgraded their sovereign credit rating to non-investment grade, and maintained a negative outlook. Financial market reactions to the downgrade were relatively muted as it was largely expected.

Outlook

Cyclical recovery in the near-term. South Africa's challenges are not related to the economic cycle. They are political in the near-term and structural in the medium-term. Political and policy uncertainty was high during 2016, weighing heavily on business sentiment and investment and we expect that it will be the main impediment to economic growth in 2017 too. Despite this, high frequency indicators point to an ongoing cyclical recovery and we expect a marked acceleration in GDP growth to about 1% in 2017. This is broadly in line with the government's 1.3% and the central bank's 1.1% forecasts.

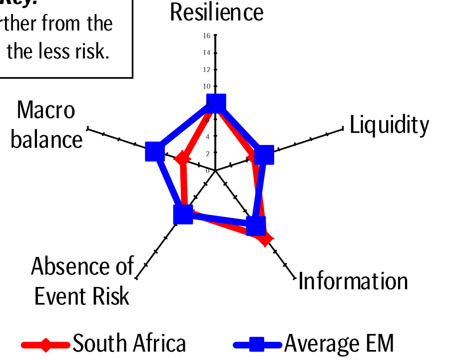
Medium-term outlook remains lacklustre. We assume that political uncertainty declines somewhat following the Presidential election in 2019. The economy should also be supported by a recovery in global trade. However, we expect only limited progress on mending the deep structural weaknesses that are holding back the growth potential. The SARB and most other observers have reduced their estimates of long-term trend growth. Most would now agree that South Africa's potential growth rate is around 1%.

Downside risks from lower growth and policy inertia. On the external side, a key risk is a hard landing in the Chinese economy, the second most important export destination for South African goods. Slower demand in China would normally also put downward pressure on global commodity prices further depressing South Africa's export incomes. Slower economic growth would make it more challenging to reach budget goals and stabilize public debt. On the domestic front, political risk dominates. It is not difficult to imagine a scenario where political infighting deepens further, puts a stop to the cyclical economic recovery, and forces the government to deviate from their fiscal consolidation path.

SOUTH AFRICA: RISK PROFILE

Key figures	**2017**
Population (millions)	54
GDP/capita (USD)	21397
Real GDP (% chg)	1.0
Inflation (%)	2.0
Curr.Acc. Balance (% of GDP)	-3.6
Reserves/imports (months)	6
Budget balance (% of GDP)	-3.2
Government debt (% of GDP)	52

Chart Key:
The farther from the centre, the less risk.



External ratings:
Fitch: BBB- / Negative
Moody's: Baa2 / Negative
S&P: BBB- / Negative

Peers:
Brazil
India
Russia

Graph: South Africa scores similarly to the average CRIS country, except on the macro-balance indicator due to large current account and budget deficits. The resilience score is somewhat misleading as it is an average of one rich and one poor income group.

South Africa: Key Economic Indicators

Macroeconomic	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
GDP (USD, bn)	368	351	319	296	333	330	337	353
GDP/capita (USD)	22978	25142	19931	18907	21397	20760	20364	21158
GDP (change)	2.5%	1.7%	1.3%	0.3%	1.0%	1.7%	2.1%	2.3%
Investments/GDP	21%	21%	21%	20%	20%	20%	20%	20%
Government finances								
Budget balance/GDP	-4.2%	-3.7%	-3.7%	-3.3%	-3.2%	-3.1%	-3.2%	-3.1%
Central gov't debt/GDP	41%	44%	47%	51%	52%	52%	53%	53%
Money and prices								
CPI inflation	5.8%	6.1%	4.6%	6.3%	5.9%	5.6%	5.9%	5.5%
Money demand (chg, yoy)	9%	10%	9%	6%	7%	8%	8%	8%
Stock prices avg.	53482	54033	54552	55034	55485	55912	56321	56717
Interest rates	5.1%	5.9%	6.2%	7.2%	7.6%	7.7%	7.6%	7.5%
Exchange rate (USD)	9.6	10.8	12.8	14.7	13.8	15.0	15.9	16.3
Trade/GDP	55%	54%	52%	51%	47%	51%	53%	55%
Oil price (Brent)	$109	$99	$52	$44	$52	$52	$59	$68
Balance of payments (USD, mn)								
Exports of goods	96 611	92 735	81 791	75 303	78 823	82 930	88 489	94 950
Imports of goods	104 172	98 708	84 749	74 234	78 852	84 691	91 178	98 090
Other:	-14 033	-12 733	-10 988	-10 599	-12 216	-12 353	-12 266	-12 132
Current account	-21 594	-18 706	-13 946	-9 530	-12 245	-14 114	-14 956	-15 271
(% of GDP)	-5.9	-5.3	-4.4	-3.6	-3.6	-4.3	-4.4	-4.3
FDI	1 713	-1 900	-3 994	-1 096	-418	311	1 191	1 646
Loan repayments	-8 702	-3 153	-2 656	-3 002	-4 866	-7 377	-10 051	-12 803
Net other capital flows	28 604	24 058	18 445	13 630	18 318	22 538	25 642	28 849
Balance of payments	21	300	-2 151	2	789	1 358	1 826	2 421
External debt and liquidity (USD, mn)								
Reserves	40 914	41 214	39 063	39 064	39 854	41 211	43 038	45 458
Total debt	141 728	140 610	139 093	141 948	152 246	164 520	177 632	190 821
o/w short term debt	27 481	27 745	28 688	29 391	31 304	33 834	36 540	39 320

Source: OEF (Oxford Economic Forecasting), IMF and SEB estimates.

Rating history		
Fitch	BBB	BBB-
S&P	BBB	BBB-

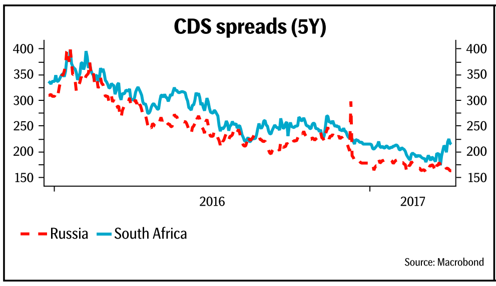
Type of government: ANC majority government headed by president Zuma

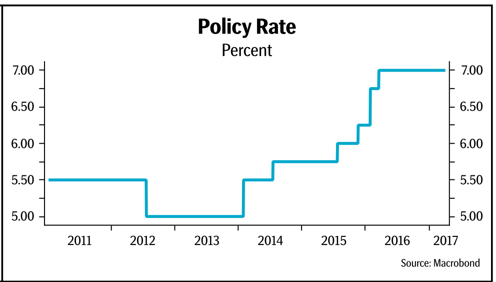
Next elections: Parliamentary and presidential elections 2019.

Other:

Latest PC deal: n.a.

Recent IMF programs: Compensatory and Contingency Financing Facility (CCFF) in December 1993.





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