South Africa

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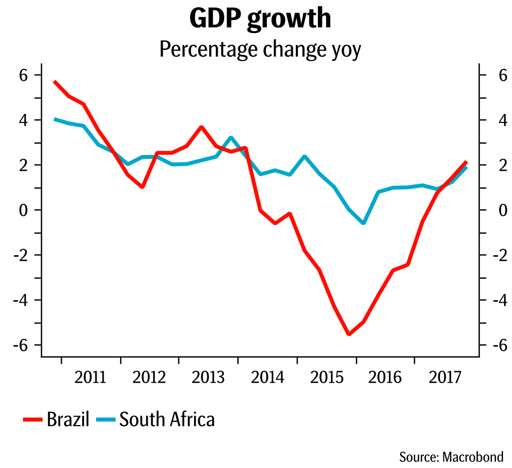
A change in leadership has reduced political risk considerably. Steps have been taken to reorient economic policies, including adopting a more restrictive budget. It remains to be seen if the new leadership will be able to push through its reform agenda despite divisions within the ANC and general elections in 2019. Meanwhile, economic activity has picked-up although growth remains low relative to the country's level of development.

Country Risk Analysis

Summary

The change in political leadership at the end of 2017 has reduced political uncertainty considerably which has been reflected in a marked improvement in financial market and business sentiment.

Meanwhile, GDP growth has been roughly as expected and thus still low considering South Africa's income levels. Activity has recently accelerated which together with the political changes has prompted forecasters to lift the near-term GDP forecasts. It remains to be seen if the new leadership will be able to implement its planned structural reforms which are crucial in order to get economic growth back on a higher and more stable path in the medium-term.



Fiscal policy, which is governed by a sound framework, is geared towards a gradual reduction of the budget deficit and a stabilisation in the government debt/GDP ratio. This is important as government debt is higher than in peer economies and on a rising trend. Recent political changes have yielded a more credible commitment to the fiscal targets.

With lower downside risks associated with domestic politics, the main risks are related to external developments such as global trade tensions. This could slow economic growth and make it more challenging to reduce the public sector deficit and to stabilise government debt. The major rating agencies cut the sovereign credit ratings in 2017, before the change in political leadership.

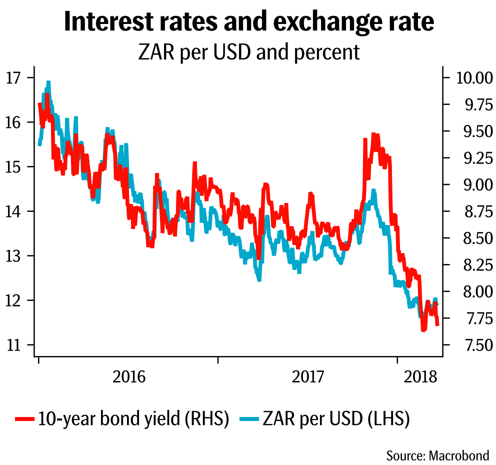
Recent economic developments

Economy showing small improvements. Economic growth has been only 1.5% 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 have been one 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 2017, GDP growth accelerated to 1.3% from upwardly revised 0.6% in 2016. This was in line with our expectations. This being said, revisions to historical data and strong growth at the end of 2017 imply that the economy could be in a slightly better shape than expected. Consequently, analysts have been revising their near-term forecasts upwards in the past months. This being said, as the population normally increases about 1.5% per year, the past year's performance still means that GDP per capita fell for the sixth consecutive year.

Inflation has dropped to long-term lows. Sluggish economic activity coupled with an appreciation of the currency since late 2016 have worked to ease price pressures. Headline inflation recently dropped to 3.8%. Meanwhile, more than a quarter of the population remains unemployed.

Improved financial market sentiment. Financial market participants have reacted positively to the political changes and to the subsequent re-orientation of economic policies. The exchange rate has strengthened while bond yields and CDS spreads have declined quite markedly since late 2017. Portfolio inflows have also been registered in early 2018 despite market jitters that have sparked outflows in many other emerging markets.

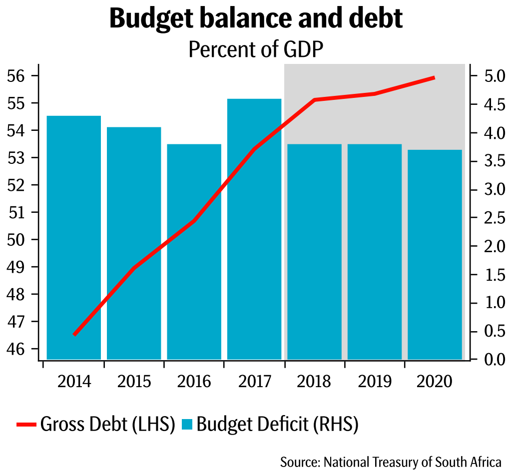


External deficit declined. Commodities dominate South Africa's export basket, in particular gold and platinum. Consequently, the recovery in global commodity prices starting in early 2016 has contributed to improved terms of trade. This favourable development continued in 2017. Despite fairly strong imports, the trade balance was in surplus which helped to limit the current account deficit to just above 2% of GDP, the lowest in several years and broadly in line with similarly rated economies. Annual transfers to Southern Africa's Custom Union amounting to about 1% of GDP continue to weigh on the deficit.

High and rising portfolio inflows. Foreign direct investments are relatively low and a significant part of the current account deficit is financed through portfolio flows. Non-resident portfolio inflows (mostly locally denominated government bonds and equities) doubled in 2017. This was sufficient to increase foreign exchange reserves with the central bank during the year. At about 50 USD bn they are equivalent to more than 5 months' of imports. This should be considered adequate given the commitment to a floating exchange rate. The share of local currency denominated government debt held by foreigners is high and rising, making the financing of the economy vulnerable to shifts in global investor sentiment. On the other hand external debt in the economy at less than 50% of GDP is low to moderate compared to peers in similar risk classes.

Economic policies

Government balances deteriorated in 2017. The country's fiscal policy framework is considered robust and better than average for most similar emerging markets. Although the government has built a track record in managing its finances relatively prudently, some deterioration was seen in 2017. The deficit rose to 4.2% of GDP from 3.3%. At the end of the fiscal year in March 2018 the government expects the deficit to have reached 4.3% of GDP (-3.6% in the previous FY).



Budget signals tightening ahead. The presentation of the budget for fiscal year 2018/19 in February 2018 was the new government's first opportunity to signal a concrete change from the past. Most analysts concluded that the budget plan, aiming to reverse some of the past year's deterioration and to stabilise government debt/GDP, was credible and built on reasonable assumptions. Nevertheless, many cautioned that very low growth environment could make implementation challenging. Another risk is that planned tax hikes could put a break on the economy.

Government debt is the key fiscal weakness. General government debt is estimated to have risen to 53% of GDP by the end of 2017 (IMF definition). The authorities expect that the announced budget measures will stabilise government debt at about 56% of GDP by early 2021. Observers such as the IMF are less sanguine and forecast that the debt/GDP ratio will continue to rise gradually beyond that point. Low economic growth makes the government's debt burden more challenging. The composition of the debt is a mitigating factor as it is mainly local currency denominated (90%) and has a long average maturity.

Contingent liabilities are important. Coming on top of the headline fiscal numbers are contingent liabilities to the government from the poorly governed large state-owned enterprises (SOE), in particular from the non-investment grade rated electricity giant Eskom. New capital injections in the giant should not be excluded. This being said, the government has taken some important steps to improve governance in several SOEs.

Banking sector relatively strong. In this still rather weak economic environment, the banking sector remains a relatively bright spot. Limited competition among banks and strong supervision is contributing to banks being well capitalized and relatively profitable, although lower interest rates have reduced profitability recently.

Political and policy uncertainty has decreased. Political risk has declined following the election of Cyril Ramaphosa as new president of the ANC, and subsequently the country's president following the resignation of Mr Zuma. Economic policy should now be more coherent and fiscal policy more prudent than we expected at the time of our previous analysis. It is important to note that although Ramaphosa enjoys strong support from senior ANC members, divisions within the party remain. This may become increasingly evident in the run-up to the general elections in 2019. The division, and hence need to balance renewal with continuity, was reflected in the composition of the newly formed government. Although important allies of Zuma were ousted and several of the former president's severe critics were reappointed to the new cabinet, several Zuma allies including his ex-wife were awarded top positions.

External rating agencies cut sovereign ratings in 2017. All three major rating agencies cut their sovereign credit ratings in 2017. Several arguments referred to a worsening political situation which, in their view, would pose risks to government finances and undermine the investment climate. It is noteworthy that the downgrades occurred before the resignation of Zuma. In March 2018, Moody's confirmed its investment grade rating.

Outlook

Brighter outlook in the near-term. Less political uncertainty and assumptions about more business friendly and fiscally sound policies contribute to a slightly more positive near-term outlook for the economy than we have previously had. Recent upticks in business sentiment could indicate firms are contemplating resuming investment activity. GDP growth is expected to rise to 2% in 2018. This would still be a low growth rate considering South Africa's level of development and not likely to have a material impact on the high level of unemployment.

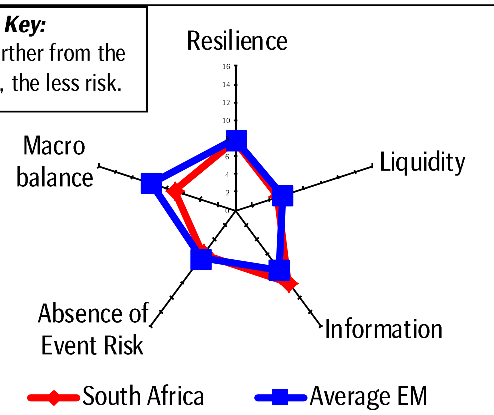
Long-term outlook depends on reform implementation. Growth prospects in the medium and long-term are much more uncertain. The central bank (SARB) estimates that South Africa's potential growth rate is 1.3%. An indicator aiming at capturing the economy's longer-term productivity and economic growth potential is the World Economic Forum's (WEF) competitiveness index. In WEF's most recent ranking, South Africa fell several notches and ranks close to Hungary and Slovakia but is clearly lagging for example Turkey. There are several long-standing supply-side constraints to growth. They include poorly functioning labour and product markets, inadequate infrastructure, poorly governed state-owned enterprises and an education system that is below the standards of most regional peers. If these structural problems are not addressed in the coming years, economic growth should remain very sluggish, which would naturally weigh on government debt metrics.

Risks to main scenario from external developments. With domestic political risk having declined, risks to our main scenario are mainly of external character. The key would probably be an escalation of global trade tensions. This would dampen exports and economic growth globally, and would also normally 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. This being said, domestic political uncertainty remains an important risk. Public frustration with large income disparities and high poverty and unemployment could easily spark rising political tensions and policy paralysis.

SOUTH AFRICA: RISK PROFILE

Key figures	**2018**
Population (millions)	54
GDP/capita (USD)	25873
Real GDP (% chg)	2.0
Inflation (%)	2.0
Curr.Acc. Balance (% of GDP)	-2.8
Reserves/imports (months)	5
Budget balance (% of GDP)	-3.8
Government debt (% of GDP)	55

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



External ratings:
Fitch: BB+ / Sta
Moody's: Baa3 /Sta
S&P: BB/ Sta

Peers:
Brazil
India
Russia

Graph: South Africa scores similarly to the average emerging market economy, except on the macro-balance indicator due to large current account and budget deficits.

South Africa: Key Economic Indicators

Macroeconomic	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
GDP (USD, bn)	351	319	297	348	412	430	452	473
GDP/capita (USD)	25142	19931	18946	22332	25873	25967	27071	28378
GDP (change)	1.8%	1.3%	0.6%	1.3%	2.0%	2.0%	2.3%	2.4%
Investments/GDP	20%	21%	20%	20%	20%	20%	20%	20%
Government finances								
Budget balance/GDP	-3.7%	-3.7%	-3.3%	-3.5%	-3.8%	-3.7%	-3.7%	-3.3%
Central gov't debt/GDP	44%	47%	52%	53%	55%	57%	58%	52%
Money and prices								
CPI inflation	6.1%	4.6%	6.3%	5.3%	5.1%	5.4%	5.4%	5.4%
Money demand (chg, yoy)	19%	19%	15%	13%	15%	16%	15%	17%
Stock prices avg.	54645	55380	56089	56787	57473	58146	58802	59444
Interest rates	5.9%	6.2%	7.2%	7.2%	6.8%	7.0%	7.6%	8.0%
Exchange rate (USD)	10.8	12.8	14.7	13.3	12.1	12.4	12.8	13.2
Trade/GDP	54%	52%	50%	49%	43%	43%	43%	44%
Oil price (Brent)	$99	$52	$44	$54	$67	$65	$66	$68
Balance of payments (USD, mn)								
Exports of goods	92 735	81 791	75 350	88 184	89 745	91 919	97 872	104 526
Imports of goods	98 708	84 749	74 252	83 013	87 878	92 137	98 145	104 731
Other:	-12 733	-10 988	-10 628	-13 268	-13 456	-13 313	-13 292	-13 388
Current account	-18 706	-13 946	-9 530	-8 097	-11 589	-13 531	-13 564	-13 593
(% of GDP)	-5.3	-4.4	-3.2	-2.3	-2.8	-3.1	-3.0	-2.9
FDI	-1 900	-3 994	-1 095	-5 069	-447	474	924	1 218
Loan repayments	-3 153	-2 687	-7 420	-13 297	-15 613	-17 924	-20 346	-22 775
Net other capital flows	24 079	18 775	15 896	28 047	31 254	34 654	36 889	39 849
Balance of payments	320	-1 851	-2 149	1 584	3 606	3 672	3 902	4 699
External debt and liquidity (USD, mn)								
Reserves (excl. gold)	41 214	39 063	39 064	40 647	42 670	44 319	46 573	49 018
Total debt	140 920	139 398	143 054	157 643	168 113	180 164	192 654	204 912
o/w short term debt	27 745	28 688	29 523	31 838	34 159	36 629	39 195	41 755

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

Rating history			
Fitch	BBB-	BBB-	BB+
Moody's	Baa2	Baa2	Baa3

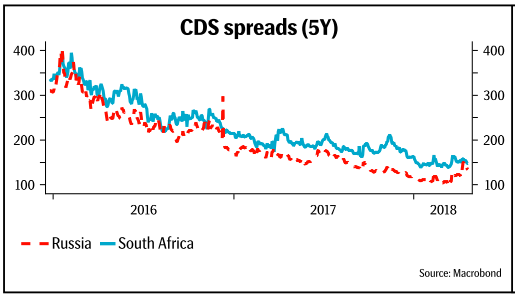
Type of government: ANC majority government

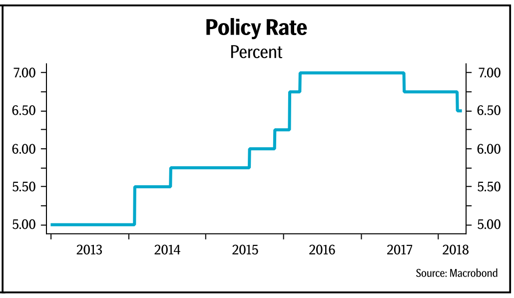
Next elections: Parliamentary and presidential elections 2019.

Other:

Latest PC deal: n.a.

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





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