South Africa

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Following a period of very low growth, the economy looks set for a gradual recovery. Public finances remain a key country risk weakness as the recovery will do little to stop government debt from edging up. Policy uncertainty has weighed on private investment appetite but may decrease following upcoming elections.

Country Risk Analysis

Summary

Following a recession in the first half of the year, real GDP grew by a relatively meagre 0.8% last year. Growth has averaged just over 1% in the past five years which is lower than average among similarly rated countries. Low growth in GDP and per capita incomes has been weighing on country risk for some time. Recovering exports and improved confidence are expected to contribute to a very gradual pick-up in 2019.

Lower economic growth last year weighed on government revenues and lifted the debt to GDP ratio. Public finances are governed by a sound policy framework but the debt metrics and significant contingent liabilities remain a key country risk weakness.

On the external side, the country's persistent current account deficit has normally been financed by portfolio flows making the economy vulnerable to shifts in global investor sentiment. However, net foreign direct investment rose significantly in 2018, perhaps reflecting expectations of improving policy clarity. Domestic private investment activity remains muted, largely due to policy uncertainty.

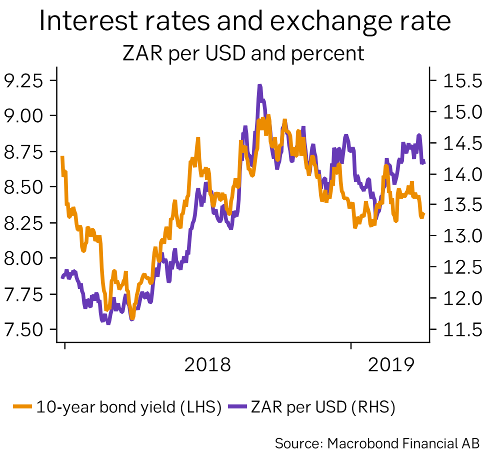
Political risk is moderate. General elections are due in May. It is widely expected that the ANC will come out as winners again which may open up for Cyril Ramaphosa's government to accelerate the hitherto very gradual pace of economic reform. Other risks are related to external developments that risk slowing economic growth, and the challenges that this would pose in reducing the public sector deficit and stabilising government debt.

Recent economic developments

Growth remains relatively low. Real GDP growth slowed to 0.8% in 2018 from 1.4% following a recession in the first half of the year. Recovering exports were the main growth engine that helped stabilise the economy towards the end of the year. Economic growth has been 1.1 % in the past five years, lower than among rating peers and clearly lower than what is required to come to grips with the country's social and labour market challenges. Consequently, the growth performance has been weighing on country risk for some time. As the population normally increases about 1.5% per year, the past year's performance has resulted in very small improvements in GDP per capita.

Moderate inflation, high unemployment. Sluggish economic activity and falling fuel prices worked to ease price pressures towards the end of 2018 resulting in an average inflation of 4.6%. Meanwhile, more than a quarter of the population remains unemployed.

Financial markets concerned about deficits. Optimism in financial markets following the appointment of Cyril Ramaphosa as new president in early 2018 was short lived. First, sentiment towards emerging markets in general turned sour in 2018 putting pressure on South Africa's rand. Second, domestic woes, including large twin deficits and a level of reserves often perceived as low, contributed to a depreciation that was among the largest of all emerging economies, and to rising bond yields. Parts of the depreciation reversed and interest rates came down towards the end of the year.



Persistent current account deficits. The current account deficit rose last year to nearly 4% of GDP, partly due to higher oil prices, and is expected to remain around these levels in the near-term as imports strengthen. For several years, the deficit has been financed by debt and equity flows. Inward foreign direct investments (FDI) have been low and over shadowed by investments made out of the country. However, in 2018 inward FDI rose significantly yielding a positive net flow. Reserves at the central bank rose slightly during the year. Although they barely cover outstanding short-term external debt, they are equivalent to more than 5 months of imports. This should be adequate given the country's flexible exchange rate.

External debt is moderate. External debt as a share of GDP has risen over the past years as non-residents have stepped up purchases of government securities denominated in rand. It is expected to stabilise at about 50% of GDP in 2019.

Economic policies

Fiscal deficits remained high in 2018. The country's fiscal policy framework is considered robust and better than average for similar emerging markets. Nevertheless, general government budget deficits have been over 4% of GDP in the past few years. In the fiscal year ending in March 2019, our house forecasters Oxford Economic expect an increase in the consolidated budget deficit to 4.2% of GDP, a reflection of lower economic activity driving revenues lower than budgeted. The budget for the fiscal year starting April envisages some loosening of the fiscal stance. The headline deficit is budgeted at 4.4% of GDP, partly a consequence of stepped up aid to the power monopoly Eskom.

Rising government debt is important fiscal weakness. General government debt is estimated to have risen to roughly 56% of GDP by the end of 2018 (IMF definition). A continued rise is on the cards as the authorities recently delayed a planned stabilisation of the debt. Now the debt ratio is expected to increase up to fiscal year 2023/24 when it should breach the 60% of GDP limit. Even the current level of government debt is higher than average among risk class peers. A mitigating factor is that the debt is mainly denominated in local currency which limits the impact of a depreciating currency. However, about 40% of the local currency debt is held by non-residents. While this may help to improve liquidity, it also increases the vulnerability to shifts in global investor sentiment.

Contingent liabilities are important. For a complete assessment, the headline fiscal numbers should be complemented by contingent liabilities to the government from the poorly governed large state-owned enterprises (SOE). For example, in early 2018 outstanding government guarantees for Eskom and South African Airlines amounted to about 7% of GDP. The government has taken several important steps to improve governance in the SOEs. However, new malpractices continue being revealed and several of the companies are requiring capital injections.

Power company Eskom in focus. By far the most important is the large state power monopoly Eskom whose financial troubles has pushed it to the brink of collapse. The company manages the country's coal-fired plants which provide most of the power generated in the economy. Recently the authorities unveiled the largest bailout in the country's history for Eskom as they will inject roughly USD 4.8 bn over three years to stabilise the company's USD 30 bn debt. The capital injection is partly financed by cost cutting measures. The company may well require further financial support.

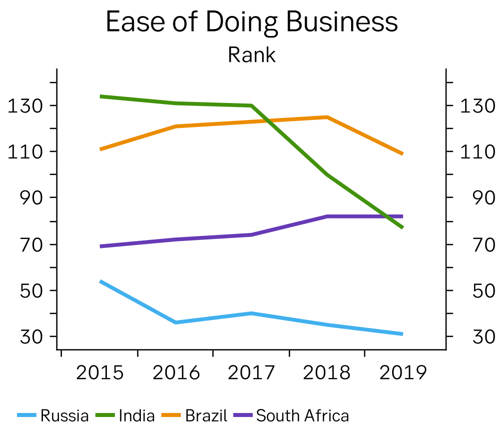
Banking sector relatively strong. The banking sector is relatively large with total assets equivalent to more than 100% of GDP. It is well capitalised and profitable on average and therefore does not markedly affect our view on country risk. A key vulnerability remains banks' exposures to large state-owned enterprises.

Monetary policy in difficult balancing act. The policy environment was challenging in 2018 as economic growth remained low but inflation was pushed up by higher oil prices and the depreciating currency. The flexible exchange rate worked as an efficient shock absorber. However, with headline inflation in the upper half of the central bank's 3-6% target range, the Reserve Bank hiked interest rates at the end of 2018. We expect the central bank to leave rates at 6.75% for the remainder of 2019.

Elections in May unlikely to lead to major policy changes. The switch from Mr Zuma to the more business friendly Cyril Ramaphosa as the country's President in early 2018 reduced political risk. However, the change may not have yielded as quick a change as some had hoped for and policy uncertainty is still high. Despite yet another reshuffling of the government, several allies of the former president Zuma remain in office. This creates policy uncertainty and acts as a brake on the pace of economic reform. Some reform proposals relating for example to land expropriation and to nationalising the central bank has created concern, not least among foreign investors. General elections are due on May 8. It is widely expected that the ANC will come out as winners again. The outlook beyond the elections largely depends on wheather Ramaphosa can unite the ANC behind efforts to clean up corruption and reduce policy uncertainty.

Structural issues

Despite the political transition, many private investors are largely on the side lines, awaiting not only policy clarity but probably also improvements to the business climate, to infrastructure, and corruption. Delays in implementing reforms in these and similar areas may be reflected in relatively weak readings in some governance related indicators. For example, South Africa has declined in Transparency International's corruption perception index for three consecutive years.



Source: Doing Business, World Bank

Furthermore, according to the World Bank's doing business index, South Africa has fallen in the rankings and now lag India. Finally on this point, a sharp fall in the World Economic Forum's competitiveness ranking of the country over the past years is another reflection of the economy's long-standing supply-side constraints. Constraints also include poorly functioning labour and product markets, poorly governed state-owned enterprises and an education system that is below the standards of most regional peers.

Outlook

Gradual economic expansion in the near-term. GDP growth is expected to rise to 1.3% in 2019, lifted by rising exports and by decreased policy uncertainty following the elections. This would still be a low growth rate considering South Africa's level of development, and is not likely to have a material impact on the high level of unemployment. Consensus forecasts are slightly lower while the government is marginally more optimistic forecasting a growth rate of 1.5 and 1.7% for the coming two fiscal years. On the fiscal side, the government has budgeted a 4.5% of GDP deficit for the fiscal year April 19/March 20. Possible additional financial support to Eskom implies a risk to meeting that target. Also, if economic growth turns out more in line with consensus, revenues may also turn out slightly lower than budgeted.

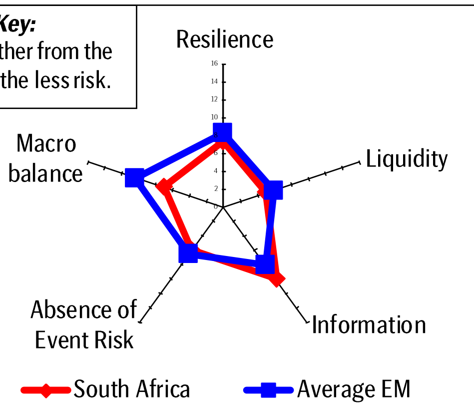
Risks to main scenario from external developments. South Africa's dependence on foreign funds makes the economy vulnerable to a change in global investor sentiment. A tightening of global financial conditions would drive up the cost of borrowing and could spark capital outflows. Possible triggers could be unexpected changes in Fed policy or broader emerging market concerns. A downgrade from Moody's, which is the only credit rating agency who rates the sovereign investment grade, could be another trigger. A sub-investment grade by all major rating agencies would lead to the exclusion from global bond indices, triggering forced sales of government bonds.

Domestic political risk. Although policy uncertainty is expected to decrease over time, political risk remains important. 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	**2019**
Population (millions)	54
GDP/capita (USD)	22791
Real GDP (% chg)	1.3
Inflation (%)	2.0
Curr.Acc. Balance (% of GDP)	-3.8
Reserves/imports (months)	5
Budget balance (% of GDP)	-4.3
Government debt (% of GDP)	56

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
Portugal
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	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**
GDP (USD, bn)	319	297	349	376	363	387	408	431
GDP/capita (USD)	22833	18549	22318	24159	22791	23363	24474	25847
GDP (change)	1.3%	0.6%	1.3%	0.8%	1.3%	1.8%	2.3%	2.4%
Investments/GDP	21%	20%	20%	20%	20%	20%	20%	20%
Government finances								
Budget balance/GDP	-4.0%	-4.7%	-4.0%	-4.2%	-4.3%	-4.4%	-4.5%	-4.4%
Central gov't debt/GDP	47%	49%	53%	56%	56%	58%	59%	59%
Money and prices								
CPI inflation	4.6%	6.3%	5.3%	4.6%	4.7%	5.5%	5.2%	5.2%
Money demand (chg, yoy)	19%	15%	13%	13%	14%	15%	16%	17%
Stock prices avg.	55380	56089	56787	57473	58146	58802	59444	60071
Interest rates	6.2%	7.2%	7.2%	7.0%	7.4%	7.5%	7.7%	7.7%
Exchange rate (USD)	12.8	14.7	13.3	13.2	14.4	14.4	14.7	15.1
Trade/GDP	52%	51%	49%	50%	53%	53%	54%	54%
Oil price (Brent)	$52	$44	$54	$71	$61	$66	$67	$69
Balance of payments (USD, mn)								
Exports of goods	81 184	76 729	88 182	93 935	96 980	102 610	109 105	115 885
Imports of goods	84 747	74 264	82 733	93 221	96 987	104 179	111 405	118 194
Other:	-10 985	-10 585	-13 740	-15 009	-13 693	-13 431	-12 900	-13 291
Current account	-14 549	-8 120	-8 291	-14 296	-13 700	-15 000	-15 200	-15 600
(% of GDP)	-4.6	-2.7	-2.4	-3.8	-3.8	-3.9	-3.7	-3.6
FDI	-3 994	-2 275	-6 069	2 450	499	896	1 153	1 351
Loan repayments	-2 687	-7 420	-8 119	-11 031	-13 065	-15 184	-17 415	-19 533
Net other capital flows	19 378	15 666	24 064	26 565	30 221	33 005	35 684	38 599
Balance of payments	-1 851	-2 149	1 584	3 688	3 955	3 717	4 221	4 818
External debt and liquidity (USD, mn)								
Reserves (excl. gold)	39 063	39 064	40 647	42 752	44 601	46 469	48 823	51 287
in months of imports	6	6	6	5	5	5	5	5
Total debt	139 398	143 055	164 975	185 575	193 839	204 729	215 344	225 671
o/w short term debt	28 688	29 523	31 733	35 603	37 321	39 361	41 478	43 485

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

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

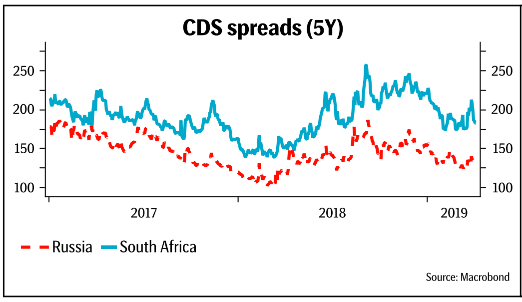
Type of government: ANC majority government

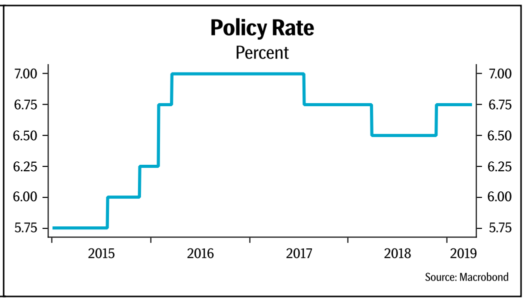
Next elections: Parliamentary and presidential elections 2019.

Other:

Latest PC deal: n.a.

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





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