Country Note | South Africa – Toxic politics

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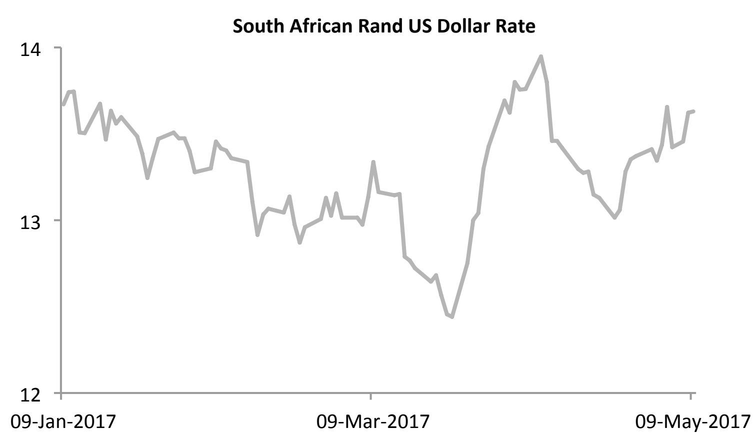
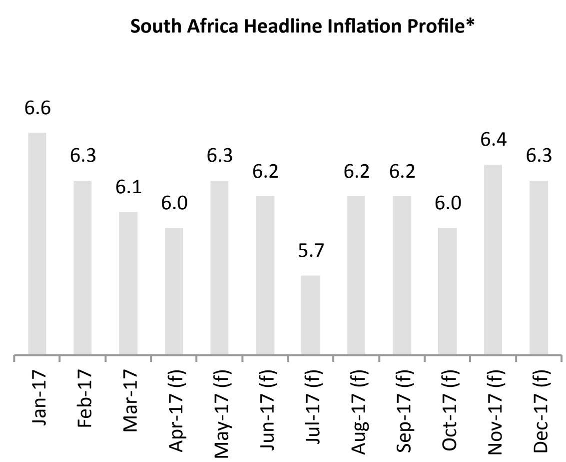
We upgrade our 2017 growth forecast to 0.7 percent, from 0.4 percent. (The IMF is more optimistic though, raising its 2017 growth forecast to 1 percent from 0.8 percent in May.) Still, the South African economy remains delicate somewhat. Some of the wear and tear came out in the Q4 2016 GDP growth data, coming out negative: -0.3 percent (seasonally adjusted and annualised). Since then, especially in Q2 2017 thus far, and amid negative political noise, it has shown remarkable grit. The positively surprising resilience can be evidenced in recent mining (7 percent of GDP) and manufacturing (13 percent of GDP) production data (March), which both beat expectations, coming out at 0.3 percent (year-on-year) and 15.5 percent respectively. (A contraction was expected for the former and the latter was significantly higher than expectations of about 4 percent.) Recent retail sales data was also quite good – turned positive in March after a year-on-year contraction a month earlier led to expectations of a continued negative trend – despite an increasingly debt-weary consumer class. There are other considerations for the upward review. Some of the constraints (load-shedding, political noise, rand weakening and volatility, drought-induced food imports and price spikes) which bogged down the economy last year have either diminished or become non-existent.

South Africa Macro Forecasts	2017	2018	2019
Real GDP, % change	0.7	0.9	2.3
Inflation, % change	6.2	5.5	6.5
Current Account Balance (% GDP)	-4.5	-4.4	-4.3
Fiscal Balance (% GDP)*	-3.6	-4.1	-4.0
USD:ZAR**	13.7	12.5	12.7

*Source: Macroafricaintel Research, *fiscal year starts on 1 April, **year-end*





*Source: SARB, Stats SA, Macroafricaintel Research, *updated monthly*

The maize harvest this year could almost double the last, albeit worries remain about a potential El Nino drought in July-September. Load shedding is now largely unheard of, with new power plants coming on stream by and large according to plan. For instance the Medupi unit 5 came online in April, adding 800MW to the grid. Such is the case now that Eskom, the state power utility, feels secure enough to pushback on green independent power producers; a negative for investor-friendliness but evidence of confidence. Political risk has increased, however, as the ruling African National Congress (ANC) prepares to replace Jacob Zuma as party president in December. Campaigns have begun in earnest. The two principal candidates, deputy president Cyril Ramaphosa and erstwhile African Union Commission chairperson and President Zuma's ex-wife Nkosozana Dlamini-Zuma, have been reaching out to delegates ahead of the elections. With Mr Ramaphosa obviously a better candidate but out of favour with Mr Zuma, tensions abound. The coming months could be very tense indeed. In-fighting in the ANC, a determined but beleaguered Mr Zuma looking to ensure his ex-wife replaces him, and deputy president Cyril Ramaphosa's ambition to be chosen instead, have caused a lot of ruckus within the party and wider South African polity. This would probably remain the case till December. Regardless, the South African economy would probably still pull ahead in 2017. Should Mr Zuma prevail at the party conference, however, a wait-and-see approach might be adopted by long-term foreign capital providers. Portfolio investors might not be so worried initially, we have found.

Populist politics may trigger further ratings downgrade

S&P Global Ratings and Fitch Ratings both downgraded South Africa's credit rating to junk status in early April, after former finance minister Pravin Gordhan was removed from his post in late March. Moody's is largely believed would follow suit, albeit opinions are divided over whether theirs would be a one-notch downgrade to just one level above junk status or two-notches down to junk status. Mr Gordhan's replacement, Malusi Gigaba, has since proved to be a little controversial, however, after a widely acknowledged good performance at the World Economic Forum in Durban in May. Concerns revolve around a much touted 'radical economic transformation' that could include among other things land expropriation without compensation, nationalisation of the South African Reserve Bank (SARB), mines and commercial banks. Already, a developmentalist state-owned bank to be spinned out of the postal service is in the works. There has been some toning down of the socialist rhetoric lately though. More realistic but still populist options are now being considered it seems. For instance, Mr Gigaba plans to use the $40 billion procurement budget at his behest to aid black businesses. And he continues to assure investors that any supposedly populist initiatives would remain within the bounds of the 2017 budget parameters. So his real intentions (and that of his principal) would probably only become obvious in October when he presents the mid-term budget and probably more so in that for the 2018-19 fiscal year in February. In any case, some sense of what these could be are already becoming obvious.

There is clearly a determination by the Zuma government to build new nuclear power plants; estimated at US$30-70 billion. After a high court ruled in April that an earlier arrangement with Russia (the authorities have similar agreements with China, France, South Korea and the United States) was inappropriate, the government announced in mid-May that new and more transparent ones would be signed instead. The return of disgraced former Eskom chief executive Brian Molefe to the state power utility in May, after a reportedly botched attempt to be finance minister, bolster suggestions in some quarters that the authorities' nuclear power plans would go ahead irrespective of the potential negative impact on the fiscus. Mr Gigaba has thus far suggested that any move on this front would only come about if the government can afford it. It is highly unlikely however that Mr Gigaba would be able to rule against any of Mr Zuma's proposals, who it has been suggested seems quite inordinately enthused about the nuclear power programme. Fears about increased corruption in government from already deplorable levels have been raised consequently. These considerations inform our expectations of likely fiscal deterioration and the upward revisions to our 2017 and 2018 deficit forecasts.

Rates likely steady for remainder of 2017

Annual consumer inflation would likely remain outside of the SARB's 3-6 percent target band (except for July perhaps) for the remainder of 2017. True, the headline figure declined in March to 6.1 percent from 6.6 percent in January and would probably be about 6 percent in April if our forecast is vindicated, it is likely to venture outside the band subsequently. Because even if food prices prove to be stable (on the back of a likely bumper maize harvest this year and hitherto ample imports to fill the gap from an earlier drought-induced decline in domestic production), power tariffs are likely to rise: Eskom secured approval in February from the electricity regulator to raise tariffs by 2 percent in the 2017/18 fiscal year. More relevant though is that the regulator also gave the power utility a carte blanche of sorts to make additional hike requests. And if crude oil prices rise as envisaged, fuel prices (and transportation costs in tandem) would probably rise as well. External factors would also weigh. The US Fed would probably raise rates twice more later in the year, after two hikes already in December 2016 and March 2017, further tightening global credit conditions. The ratings downgrade to junk status and highlighted domestic and external factors have motivated calls in some quarters for the SARB to hike rates. Governor Lesetja Kganyago has expressed scepticism about whether such a move would be differential to foreign portfolio and direct investments. More importantly, a rate cut is almost certainly out of the question this year. Thus, we expect the repo rate to remain unchanged at 7 percent for the remainder of 2017. Our inflation forecasts (at this time) support keeping it that way till end-2018.

South Africa	Q2 2017	Q3 2017	Q4 2017	Q1 2018
Policy Rate, %	7.0	7.0	7.0	7.0

Source: Macroafricaintel Research

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