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Old sores put pressure on the rand

- **South Africa has fallen out of favour with investors. Since the start of the year, the rand has fallen sharply and CDS spreads have risen substantially.**
- **Funding the current account deficit with short-term debt securities has made South Africa vulnerable to changes in investor sentiment.**
- **Politics are a swing factor. An important issue in the elections that will be held in 2019 will be a proposed amendment to the Constitution to allow land expropriation without compensation.**
- **Investors fear that South Africa may go down the same path as Zimbabwe if this proposal actually becomes law.**
- **However, our view is that it will not come to that and that the rand will recover.**

Weak growth and a persistent current account deficit make South Africa vulnerable
Economic growth in South Africa is weak. The economy grew by just 1.3% in 2017. We are allowing for the possibility of some catch-up demand this year and next. As a result, GDP growth will rise slightly, but still not exceed a very modest 1.5%. The growth is mainly due to higher household and government spending. The increase in investments is zero. Despite the fairly high capacity utilisation rate, companies are preferring to adopt a wait- and-see approach. Foreign trade is also making a negative rather than a positive contribution because imports are increasing faster than exports. Against this background, the current account deficit is likely to rise further from 2.5% of GDP in 2017. However, this rise will be modest as the price of precious metals such as gold, which is still an important export product of South Africa, is expected to rise.

South Africa is mainly debt-financing the persistent current account deficits. External debt has nearly doubled over the past decade to 45% of GDP in 2017. Nevertheless, the repayment and interest obligations on this debt were limited to 3.5% of GDP, mainly due to the low interest rates. But a large part of the debt is short term. If interest rates rise internationally, for instance due to an escalation of the international trade dispute or the tightening monetary policy of the US central bank, the debt servicing obligations may quickly increase.

On the other hand, South Africa's foreign exchange reserves are large enough to pay for nearly five months of imports and it has sophisticated and deep financial markets. It also has a strong domestic investor base formed by large pension funds and banks. The size of the banking sector equals 110% of GDP. On balance, the banks are liquid, well-capitalised and profitable. Moreover, the volume of non-performing loans is within bounds.

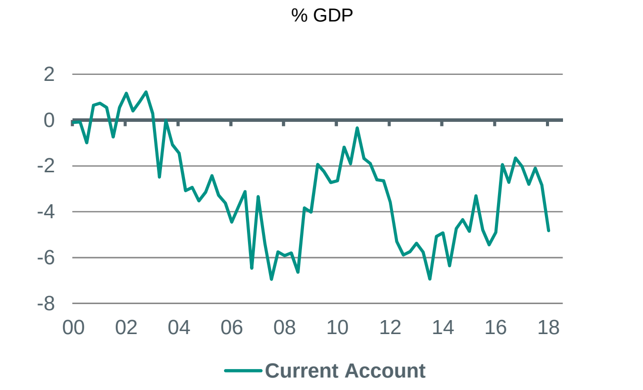
Changing of the guard creates hope of more robust public finances

More robust public finances could also contribute to financial stability. Debt servicing obligations are the fastest-rising component of government spending. In the aftermath of the global credit crisis, tax revenues have fallen and public spending has increased. Owing to this combination of factors, the country has run considerable budget deficits since 2007. In 2017 the deficit was 4.4% of GDP. Government debt doubled to 53% over this period.

Decade of slowing economic growth...

Source: Thomson Reuters Datastream

...and persistent current account deficits



Source: Thomson Reuters Datastream

Public debt must be stabilised if economic shocks are to be absorbed in the future. The resignation of Jacob Zuma in February this year and the appointment of Cyril Ramaphosa as President is positive news in this respect. By reshuffling his cabinet, the new President has been able to reassure credit rating agencies. He reappointed Nhlanhla Nene, who had been removed by Zuma but commanded universal respect, as Finance Minister. Nene quickly introduced measures that herald a sounder budget, such as an increase in the VAT rate by one percentage point to 15%. The budget deficit is expected to be 3.6% this year.

This does not alter the fact that Mr Ramaphosa cannot be expected to create miracles. Only after the elections in 2019 will he have more freedom to define policy. In the run-up to the elections, the President must accommodate various factions of the African National Congress (ANC) that needs to be kept on board. Getting the different factions to unite on a course of action is of great importance to Mr Ramaphosa because the ANC is no longer the omnipotent party it once was. The party won the municipal elections in 2016 with just a 54% majority. Consequently, the ANC cannot afford any further fragmentation, such as the departure of Julius Malema with his left-populist Economic Freedom Fighters (EFF).

Pressing need of structural reforms

In the years immediately following the abolition of apartheid in 1990, the South African economy grew strongly. But in the past decade, the economy has stagnated as a result of incoherent policies. Compliance with existing laws and regulations has also often been inadequate. Trust in politics was damaged by corruption scandals. In the absence of political trust, few reforms materialised. Sentiment among households and businesses suffered as a result. This in turn caused a lag in the growth of consumption and investment. Growth has also been hampered by defective infrastructure for both transport and energy and by crime, HIV-related health problems, and – more recently – the persistent drought and low commodity prices.

No scope for further monetary easing...

Source: Thomson Reuters Datastream

...as inflation running at the top of central bank's target

Source: Thomson Reuters Datastream

It is hoped that after the elections Mr Ramaphosa will accelerate the pace of reform again. More competition and product market reform are high on the wish list. At present, there is too little incentive for companies to boost productivity and to innovate. This applies in particular to state-owned enterprises. The services they provide in the fields of telecoms, transport, water supply and electricity are often substandard. Regular disruptions in these services are hampering economic development. Moreover, their weak financial management means they also pose a threat to public finances. The government has issued guarantees on loans to state-owned companies to the tune of 16% of GDP. The new president has taken a first step towards reorganising these companies by replacing the top management of South African Airways and energy company Eskom.

Owing to the lack of competition, companies can demand higher prices than would otherwise be the case. In the past decade, inflation has averaged 6% and has thus been at the top of the central bank's target range of 3-6%. Inflation expectations were also at the top of this target range. The central bank is aiming to reduce both the inflation rate and inflations expectations to around 4.5%. Inflation was running at 4.6% yoy in June, but is likely to rise again shortly as a result of energy prices, the recent increase in VAT and the recent fall in the rand. A further cut in the repurchase rate, which the central bank reduced by 25 basis points to 6.5% in March, is therefore not on the cards for the time being.

Fears of a repeat of Zimbabwe judged premature

A final and very thorny issue is land reform. During apartheid, many black communities lost their land. Only the small white minority could own land. The government has for years wanted this land to be returned to its original owners, but this has proved difficult. Those entitled to the land are often hard to trace. Disputes also mean that the pace of land reform is very slow. 10% of agricultural land has been redistributed since 1994, which is only a third of what was then intended. This is a problem, if only because without clearly defined property rights little is invested in farming and the growth of productivity in this sector lags behind.

High growth of unit labour costs...

Source: Thomson Reuters Datastream

...due to weak increase in labour productivity

Source: Thomson Reuters Datastream

To speed up the pace of land reform, the ANC recently voted to submit draft legislation. The planned amendment to the Constitution is intended to allow expropriation without compensation. At present, expropriation is permitted only if it is in the public interest and compensation is paid. The proposed amendment to the law could accelerate the pace of land reform.

A major objection, however, is that the proposal evokes memories of Zimbabwe, where white farmers were arbitrarily driven off their farms. Many of these farms then fell into disrepair due to the ignorance of the new managers. The ensuing fall in production plunged the country into an economic crisis. The chance of a repetition is making investors cautious. The proposed amendment to the law has also gone down badly with US President Donald Trump. His angry tweet about it fuelled fears of possible trade sanctions, which are his favourite means of exerting pressure.

We believe that the amendment to the Constitution will eventually not be passed. In view of the stable rating outlook, credit rating agencies S&P, Fitch and Moody's seem to share our view. A two-thirds majority is required in Parliament for the amendment. As noted previously, support for the ANC is shrinking at a time when the more moderate opposition Democratic Alliance (DA) is attracting more and more voters. It is questionable, therefore, whether the ANC will obtain sufficient seats in the elections to amend the Constitution.
And even if such a majority does materialise, the amendment will not have the same effect as in Zimbabwe. First, because legal institutions in South Africa are much more highly developed. And, second, because the scope of the amendment is limited. In a letter to the *Financial Times*, Mr Ramaphosa has given an assurance that the bill mainly relates to land lying fallow, land bought purely for speculation and dilapidated buildings.

Trust of foreign investors dented nonetheless

This does not alter the fact that the bill is at odds with the government's stated aim of attracting more long-term investment from abroad. It scares off investors, particularly as it follows previous proposals that also dented their confidence, such as the 2017 bill to prohibit foreigners from buying agricultural land and restricting them to taking long leases, and the plans to restrict access to international arbitration in disputes.

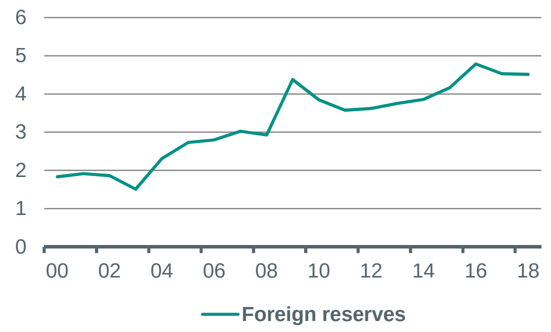
Rand under renewed pressure this year...

Exchange rate

Source: Thomson Reuters Datastream

...despite adequacy of foreign reserves

Measured by reference to imports in months



Source: Thomson Reuters Datastream

The plans to nationalise the central bank have also upset investors. The shares of the central bank are still in private hands, which is something that is unusual internationally. The measure would therefore bring South Africa more into line with the rest of the world. But the announcement has been interpreted as a sign that the government is seeking to curb the autonomy of the central bank and gain more influence over monetary policy.

Against this backdrop, it could be argued that the recent violent exchange rate reaction of the rand during the Turkish crisis was not really prompted by strong similarities with Turkey. Admittedly, the country has a current account deficit, public finances are deteriorating and there is uncertainty due to political squabbling. But the appointment of President Cyril Ramaphosa has definitely improved the economic outlook. In addition, South Africa has more moderate inflation, larger foreign reserves and a slightly lower foreign debt than Turkey. We are also taking into account that the US dollar will eventually lose momentum and that commodity prices have already bottomed out. That will be beneficial for South Africa. For this reason, we believe that the turmoil among investors will fade away and we maintain our forecasts for the rand exchange rate against the dollar of 14.50 at year-end 2018 and 14.00 at year-end 2019.

Key forecasts for the economy of South Africa

	2015	2016	2017e	2018e	2019e
GDP (% yoy)	1,3	0,6	1,3	1,5	1,5
CPI inflation (% yoy)	4,5	6,6	5,2	5,1	5,4
Budget balance (% GDP)	-4,3	-3,9	-4,4	-3,5	-3,5
Government debt (% GDP)	50	51	53	52	51
Current account (% GDP)	-4,6	-2,8	-2,5	-2,5	-3,0
Gross fixed investment (% GDP)	20,4	19,5	18,7	18,8	19,1
Gross national savings (% GDP)	16,4	16,6	16,1	16,2	16,5
USD/ZAR (eop)	16	14	14	15	14
EUR/ZAR (eop)	17	14	17	17	18

Economic growth, budget balance, current account balance for 2018 and 19 are rounded figures
Source: EIU, ABN AMRO Group Economics