ABSA

Economic Research

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South Africa Quarterly Perspectives: Q1 18

New ANC leaders; old economic issues

- Although the ANC narrowly elected Deputy President Ramaphosa as the new party president, the rest of the elections manifested the party's deep factional divide. Even so, the ANC is still likely to secure the early exit of Jacob Zuma as state president, allowing Ramaphosa to make some important changes. As regards Zuma's position, 13 January is an important date to watch, given the prominence of the ANC's birthday celebrations then.
- Growth momentum has been solid if unspectacular; we forecast 1.4% GDP growth in 2018. The consumer is doing better than we expected, although the outlook remains muted given likely big tax hikes in the next budget. A big jump in private sector fixed investment in Q3 was a welcome surprise, but it may not be sustained unless recent and prospective political developments engender higher confidence.
- External balances have been much stronger than we expected, and the current account deficit could print as low as 1.4% of GDP in Q4 17 and 2.3% in 2018. Improved terms of trade and subdued import demand have been key here.
- CPI inflation is likely to bottom soon, but some upside risks to the trajectory have abated materially, although new ones seem to be manifesting. We expect the CPI to track inside the 3-6% target range for the foreseeable future. Although the market is now pricing in rate cuts, we think the SARB is likely to look through current rand strength and keep rates on hold at 6.75%.
- Fiscal policy is a major weakness with a projected revenue shortfall in FY 17/18 of 1% of GDP according to the latest Treasury forecast and large upside spending risks in FY 18/19 from the public sector wage negotiations and President Zuma's promise of free university education. We believe taxes are likely to rise in February. State-owned companies remain a major source of fiscal and credit ratings risks.
- Moody's is more likely than not to downgrade South Africa to Ba1 once it finishes its credit rating review around the end of February unless Ramaphosa demonstrates some early big policy wins. Fitch and S&P will likely sit tight for now.
- We expect the ZAR to weaken back to ZAR13.80/USD by end of Q1 18 and 14.10/USD by year end. After a strong relief rally in the wake of the ANC elective conference, we believe the ZAR is especially vulnerable to tighter global policy rates, persistently weak local GDP growth and lingering threat of a sub-IG Moody's downgrade.

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The South Africa Quarterly Perspectives series of reports outlines our latest macroeconomic forecasts for South Africa and discusses the major macroeconomic themes for the quarters ahead. The forecasts presented in this note are largely based on output of our proprietary demand-orientated macro model with production function supply-side constraints. It is run off a comprehensive macro data set up to Q3 17, as published by Statistics South Africa's National Accounts and the South African Reserve Bank's latest Quarterly Bulletin, updated for other relevant data published more recently.

The ANC's electoral conference: broadly positive but with some reservations

The ANC chose Deputy President Ramaphosa as its new leader, but significantly constrained him by electing representatives of the Zuma faction in roughly equal numbers to both the Top Six and the National Executive Committee; ongoing paralysis on key policy and political decisions is a risk

After a year of elevated political tension and uncertainty, the African National Congress (ANC) chose new leadership at its 54th National Conference in December. Its choices reflected the deep factional divide running down the centre of the party. Although it narrowly elected Deputy President Ramaphosa as the new party president, it also significantly constrained him by choosing three putative Zuma allies in the remainder of the Top Six. However, power creates its own realities and one or two of the Top Six officials, who might previously have supported the Zuma faction, could now align behind Ramaphosa. The ANC national conference also elected a National Executive Committee (NEC) that appeared pretty evenly split down the middle, which is significant given the NEC is the highest decision-making body of the ANC in between National Conferences; the splits in the Top Six and the NEC, which reflect the bitter factional divide within the ANC, risks continued paralysis on key political and policy decisions (such as efforts to root out corruption), especially given the NEC takes decisions by consensus. However, as with the Top Six, the NEC may decide on balance to support Ramaphosa. Positively, however, the conference did not collapse, which would have risked considerable legal uncertainty and political instability. The successful conclusion of the conference, despite some reservations about the manifestation of the factional divide, should allow the ANC to move forward, and refocus its attention on general elections due sometime in Q2 19.

The main thing to watch now is whether Ramaphosa and his allies on the NEC are able to push through an early exit for Jacob Zuma as president of the country.

One of first key tests for the new NEC will be to see its response if Ramaphosa now seeks to have Jacob Zuma recalled as state president. Significantly, the old NEC, which was also evenly split between the two factions, failed in two previous motions to recall Zuma. However, even with an NEC that is evenly divided between the factions, we think that there is considerable motive now for the ANC to remove Zuma from the state presidency as soon as possible. Zuma is deeply unpopular with the electorate at large, and his retention as head of state could prove to be a significant constraint for the ANC as it tries to rebuild its reputation ahead of the general elections due in Q2 19. Efforts are underway to persuade Zuma to step down voluntarily soon according to articles in Business Day and News 24 on 11 January, but failing this the NEC could instruct the ANC's parliamentary caucus to hold a vote of no confidence. We think 13 January is a key date at which a possible announcement regarding President Zuma's resignation or recall could be made, given the prominence of the ANC's 106th birthday celebrations then. Note that Ramaphosa would not automatically succeed to the post: were Zuma to step down, parliament would have to vote for the new state president.

If Ramaphosa ascends to the state presidency soon, we think he can make important gains, despite the factional divisions within the ANC

If Ramaphosa can lever Zuma out of the state presidency soon, we think important gains could be made, despite the fact that the Top Six and the NEC once again appear evenly divided. Although the ANC as a party is supposed to take decisions collectively and enjoy primacy above all its deployees, including the president, the state president still enjoys significant power, particularly via his ability to appoint cabinet ministers and other key officials such as the head of the National Prosecuting Authority. He also has significant power to shepherd (or frustrate) policy implementation – as President Zuma has shown during his tenure. A wholesale revamp of the cabinet with new technocratic appointments in some of the more troubled portfolios like finance, public enterprises and mineral resources, could do wonders to lift business confidence and strengthen efforts to root out

corruption. President Zuma's surprise decision earlier this week to appoint a judicial commission of inquiry into state capture (after more than a year of trying to avoid the legally binding recommendations of the former Public Protector in this matter) could be viewed as a pre-emptive move to forestall his potential recall by the ANC NEC (given that the party itself resolved at the National Conference that the commission of inquiry should be established without delay) and to have the ability to set its terms of reference. However, despite Zuma's acquiescence on this issue, we think the big sections of the party will still want him to vacate his office, one way or another. But there is still some ongoing uncertainty as to how quickly, and under what terms, he can be encouraged to step down or recalled from the state presidency. We are hopeful, but it will not be simple for Ramaphosa and his allies to secure.

Two radical policy proposals produced at the conference will also be a key political test for the new leadership of the ANC

Further ahead, beyond the near-term issue of Zuma's position, a new administration would face a number of policy challenges including deciding how to proceed with the conference's adoption of some radical policy proposals. Significantly, the conference resolved to allow land expropriation without compensation (EWC) as a means to effect faster land redistribution, although this populist approach is to be subject to a sustainability test, such that it does not undermine food production or the banking system, which has significant claims on farmers. Adoption of EWC as a policy plank proved a highly contentious move even within the ANC, not least because putting it into effect will require the government to seek an amendment to Section 25 of The Constitution, which in turn would require the ANC to cooperate in parliament with opposition parties such as the Economic Freedom Fighters to achieve the required two-thirds majority needed for a constitutional amendment. And of course President Zuma's announcement at the start of the conference that the ANC would introduce free university education for poor and working class students was also an expensive policy surprise that the new leadership of the ANC will likely have to live with, even though it was not properly considered by the conference delegates and the National Treasury has warned against it. The ANC's National Conference also decided to nationalise the South African Reserve Bank. All these are potentially quite significant populist policies, and it will be interesting to see how aggressively the new ANC leadership moves to implement them. The ANC in government has a long record of deprioritising more challenging policy resolutions of the party.

Growth momentum remains subdued

The economy has grown at an annualised pace of 2.4% since the recession

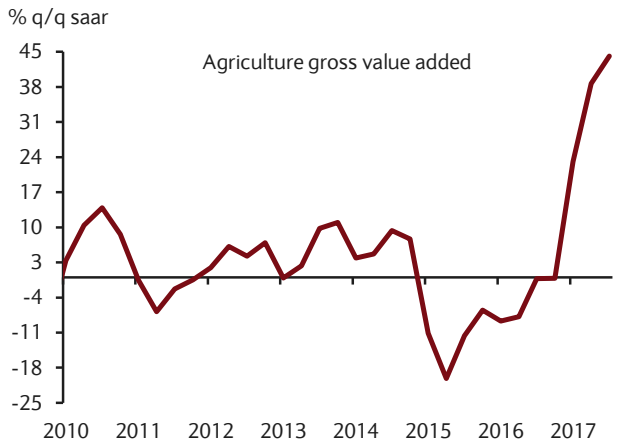
While GDP growth has recovered since the recession in Q4 16-Q1 17, its pace remains muted, at an average 2.4% q/q annualised in Q2 17-Q3 17. From the perspective of the production side of the national accounts, most of the recent growth has been driven by the primary sector. For example, agricultural production has posted a marked recovery from the drought, with record maize and other summer crop harvests this year. Total agricultural production rose by 44.2% q/q saar in Q3 17, contributing 0.9pp to the 2.0% q/q saar GDP growth rate (Figure 1). Meanwhile, mining output expanded by 6.6% q/q saar to account for 0.5pp of the Q3 quarterly GDP growth rate (Figure 2). The manufacturing sector also contributed 0.5 pp to the 2.0% Q3 GDP print but the services sector hardly grew at all.

The available activity data for Q4 so far are mixed

There is scant activity data for Q4 yet, but what is available presents a mixed picture. Mining production (8% of GDP directly) still appears to be doing well. If October mineral output levels were sustained for the remainder of Q4, the sector is set to grow 1.7% q/q saar. Despite ongoing regulatory and policy uncertainty, the mining sector's output has been buoyed by the stronger commodity price mix recently (Figure 3), especially for bulk minerals such as coal and iron ore. The manufacturing sector also seems to be doing OK. The November manufacturing production print came in stronger than expected, up 1.7% y/y compared to a consensus forecast of 0.5% y/y and our forecast of 0.9% y/y. Even under an assumption of unchanged output levels in December, Q4 17 manufacturing sector

FIGURE 1

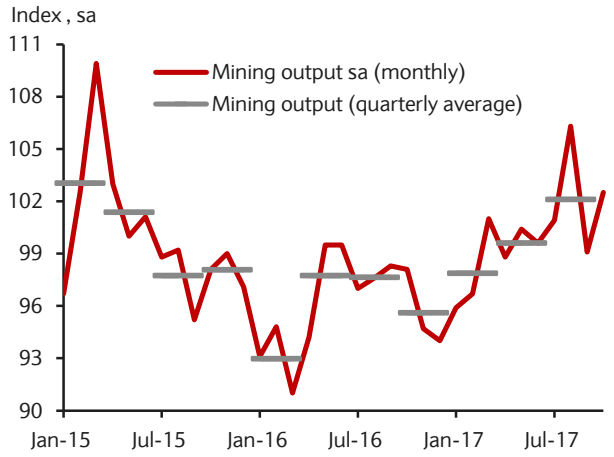
Strongest expansion of agricultural sector in over 20 years



Source: Statistics South Africa, Absa Research

FIGURE 2

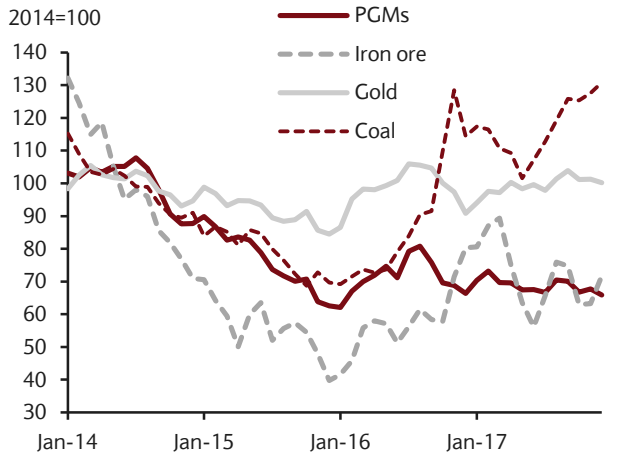
Mining output has risen over last three quarters



Source: Statistics South Africa, Absa Research

FIGURE 3

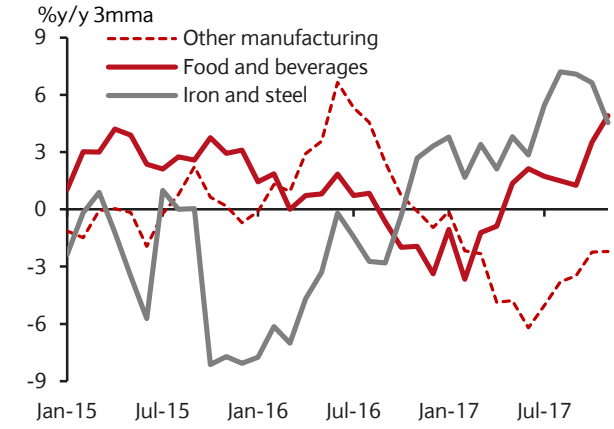
Since 2015 iron and coal prices have risen



Source: Bureau for Economic Research, Markit, Absa Research

FIGURE 4

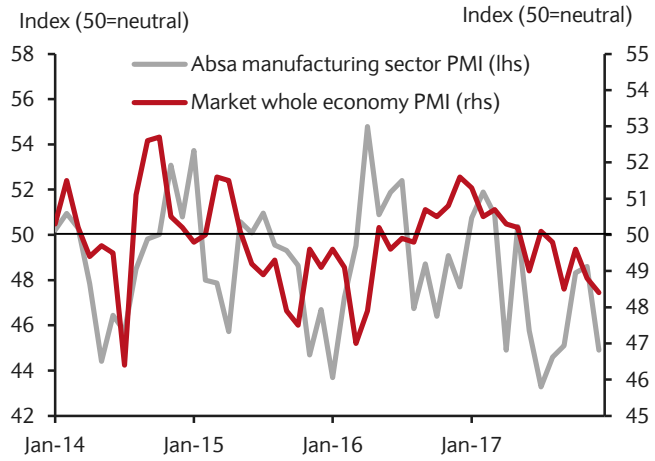
Aside from food and steel, manufacturing output is down



Source: Statistics South Africa, Absa Research

FIGURE 5

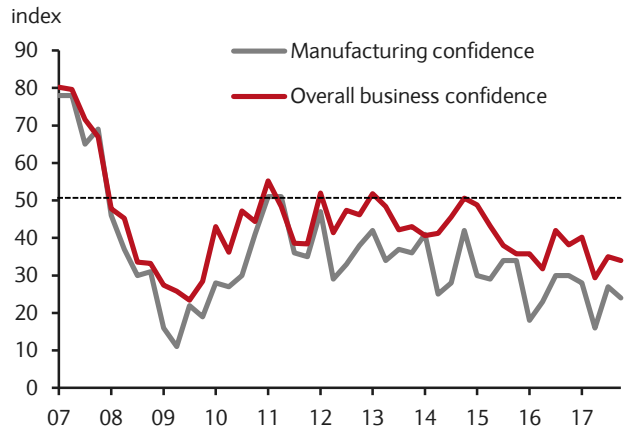
Both PMIs have been languishing below neutral



Source: Thompson Reuters, Absa Research Bureau for Economic Research, Markit, Absa Research

FIGURE 6

Manufacturers are more pessimistic than the overall BCI



Source: Bureau for Economic Research, Absa Research

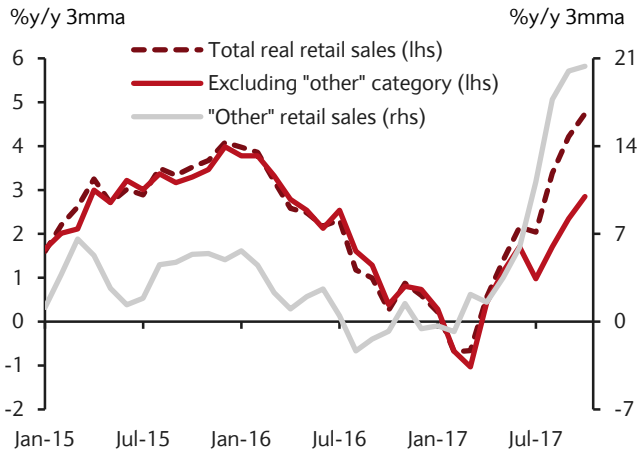
output would still have grown by 3.5% q/q saar. However, recent growth in the manufacturing sector growth is quite narrowly based, stemming really from just two sectors - iron and steel and food and beverages - which together account for 44% of total manufactured output. Excluding these, manufacturing output would be down 2.2% y/y 3mma (Figure 4). We think the outlook for the manufacturing sector remains rather gloomy. The Absa PMI, which covers only the manufacturing sector, has tracked below the neutral level of 50 since May (Figure 5), and December's print was especially weak, although near-term expectations improved. Also, Absa's Q4 survey of the manufacturing sector found 76% of respondents were dissatisfied with current business conditions (Figure 6). A net balance of 30% expected conditions to be worse in twelve months time, although they did report a big improvement in their sentiment about export prospects. Also, ongoing drought in the Western Cape and looming drought signs elsewhere in the country might undermine the food-related manufacturing businesses.

StatsSA's reported strong growth in retail sales needs to be taken with a pinch of salt, but even so the consumer is not collapsing

Meanwhile, from the trade sector, real retail sales in October were 1.8% better than the Q3 average saar and wholesale sales were 2.5% stronger saar. However, importantly, much of the apparent recent strong growth in overall retail sales (up 4.0% y/y July-October) comes from the miscellaneous category which includes gold coin sales, second-hand sales and online sales, and which has accounted for about 12% of retail sales since mid-year, and which rose a conspicuously large 18.7% y/y July-October (Figure 7). If this category is excluded, real retail sales growth has proven significantly more muted than the headline figures suggest, up just 2.2% y/y in July to October. StatSA have not disclosed any additional information about the drivers of the large increase in the "other" category, and we think it could have been due to a sample change with StatsSA simply booking the increased measurements as volume growth. However, one shouldn't get too pessimistic about the current pace of consumer spending, since passenger vehicles showed strong growth in October and November, although December was weak (Figure 8). StatsSA puts overall real household consumption expenditure growth in Q3 at 2.6% q/q saar, a more normal pace after the yo-yo of the Q1 17 contraction followed by the exceptional Q2 17 surge (Figure 9). Our forecast for Q4 17 based on our macroeconomic model is 0.8% q/q saar. Despite positive political developments recently, we expect the consumer to remain in a defensive mindset, and for household spending to remain relatively muted given likely big tax increases in the 2018 Budget, after big personal income tax hikes in 2017 (Figure 10). We forecast household consumption spending to rise 1.3% in 2018 and 1.7% in 2019.

FIGURE 7

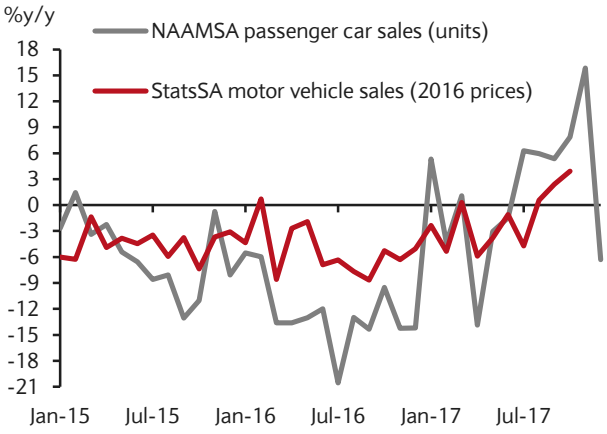
"Other" retail sales have risen strikingly quickly



Source: Statistics South Africa, Absa Research

FIGURE 8

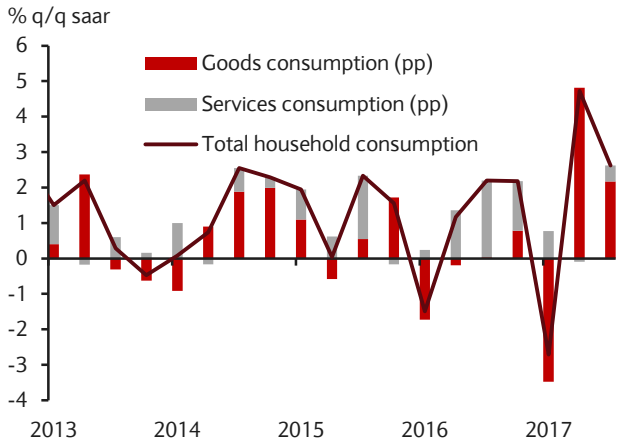
Car sales were strong in H2 17 but plunged in December



Source: NAAMSA, Absa Research

FIGURE 9

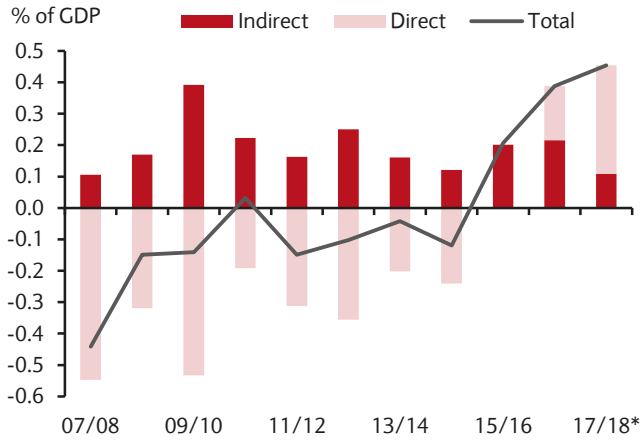
Pace of household consumption normalised in Q3…



Source: Statistics South Africa, Absa Research

FIGURE 10

…despite large hikes falling on the consumer in the budget



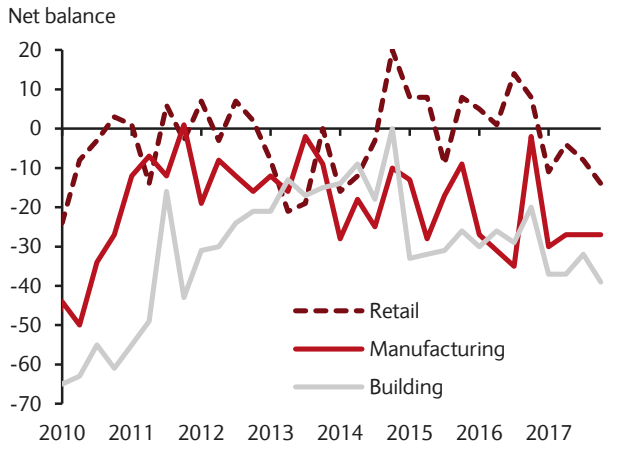
Source: National Treasury, Absa Research

There is no sign of a fully fledged crisis for consumers; arrears on consumer credit in particular look well contained

Overall, however, the available data do not point to a consumer in a state of crisis. Perhaps the jobs picture is not as gloomy as surveys of formal businesses suggest (Figure 11). Intriguingly, Statistics South Africa's survey of households (the Quarterly Labour Force Survey) shows much stronger job growth than its other labour market survey, Quarterly Employment Statistics, which is based on formal enterprises' payroll data (Figure 12). Perhaps some income generation via the gig economy is not being properly captured in the jobs data. And the official data show that wage settlements and income growth still remain fairly elevated, at least until Q3 (Figure 13). Bank lending to households remains subdued, below the rate of inflation (Figure 14), but this seems due as much to household caution as bank restraint, since data from the National Credit Regulator and consumer credit bureaus show no worrying increase in arrears (Figures 15 and 16). Meanwhile, the "credit health" of consumers appears to be improving (Figure 17) and their net wealth improved slightly in Q3 (Figure 18), despite the slowdown in the housing market. Generally, however, the negative sentiment seems to be encouraging households to adopt defensive positions. They continue to deleverage, and their net savings remains in positive territory (Figures 19 and 20).

FIGURE 11

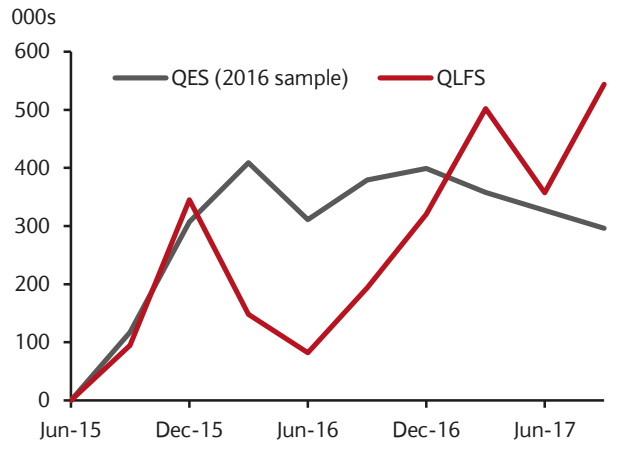
Surveys of formal businesses show they want to shed labour



Source: Bureau for Economic Research, Absa Research

FIGURE 12

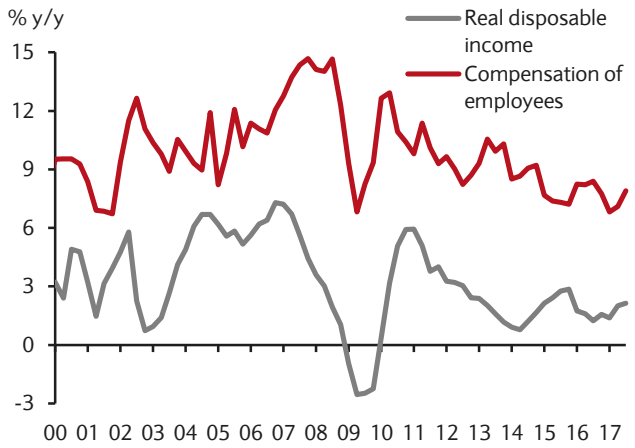
Confusing picture as regards job creation



Source: Statistics South Africa, Absa Research

FIGURE 13

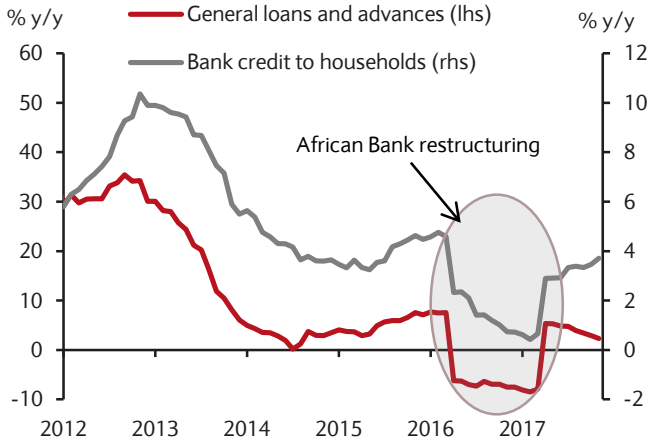
Wage settlements and income growth remain high



Source: Statistics South Africa, SARB, Absa Research

FIGURE 14

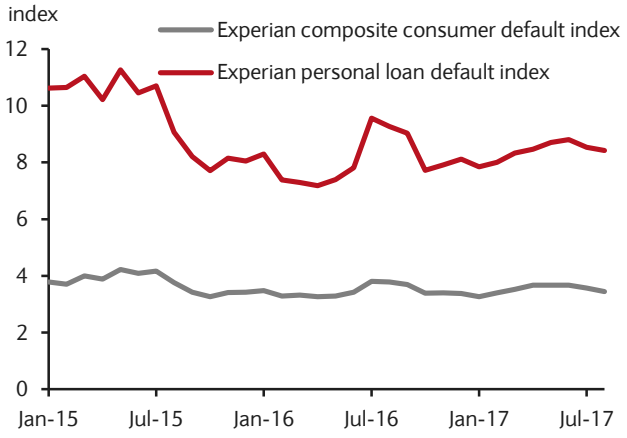
Bank lending to households remains muted



Source: SARB, Absa Research

FIGURE 15

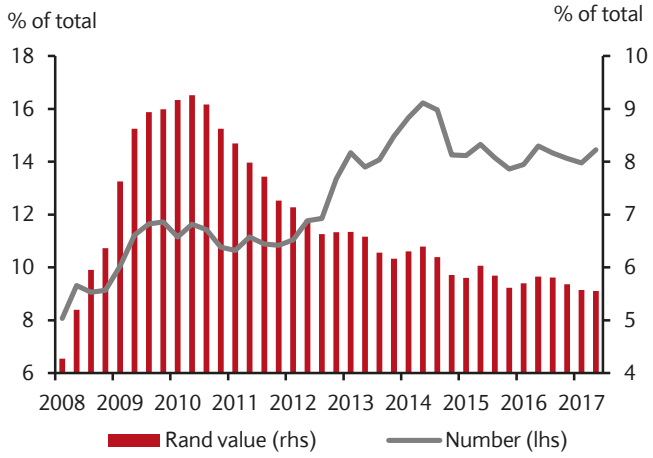
No sign of accelerating consumer defaults



Source: Experian, Absa Research

FIGURE 16

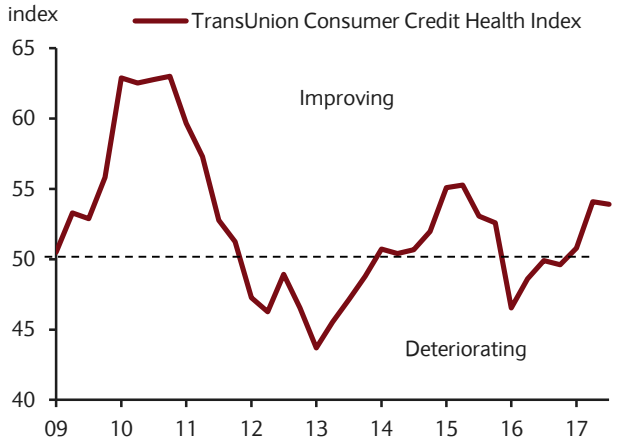
Consumer credit arrears (3+ months) were stable to end-Q2



Source: National Credit Regulator, Absa Research

FIGURE 17

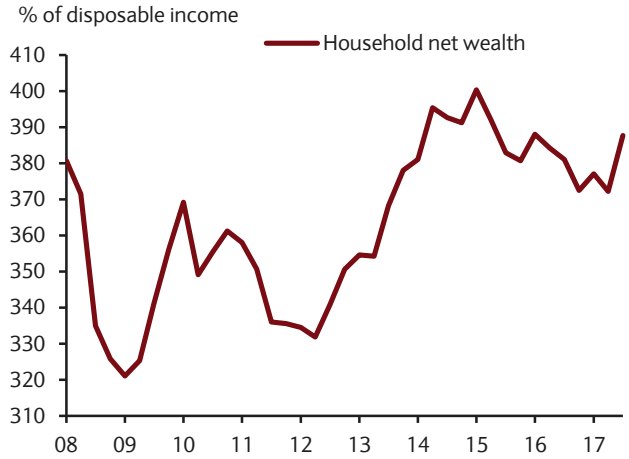
Consumer credit health appears to be improving



Source: TransUnion, Absa Research

FIGURE 18

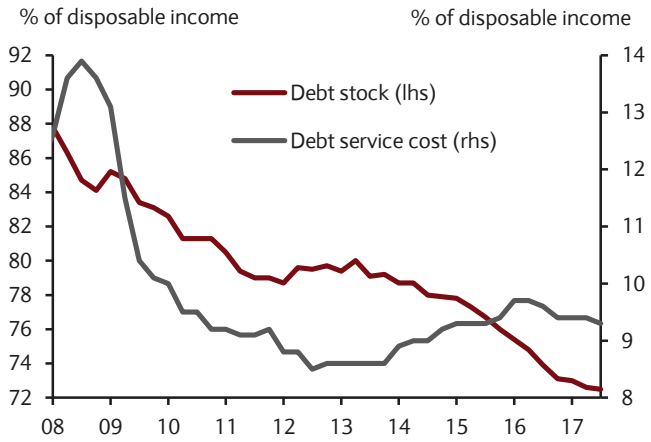
Household net wealth recovered a bit in Q3 17



Source: SARB, Absa Research

FIGURE 19

Households continue to deleverage…



Source: SARB, Absa Research

FIGURE 20

…with household net savings moving into positive territory

Source: SARB, Absa Research

Private business investment surprised with a material expansion in Q3, but it is unclear if this welcome development will be sustained

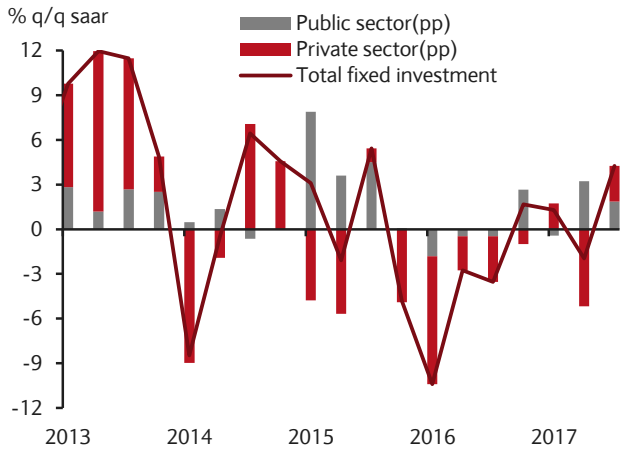
Fixed investment spending produced a very welcome surprise in the third quarter, expanding by 4.3% q/q saar, the strongest pace of growth in over two years. Notably it was driven in equal measure by both the public and private sectors (Figure 21). Private business enterprises' capex grew by 4.1% q/q saar, the strongest pace of growth since 2014, and accounted for 56% of the 4.3% growth figure. In our view, this solid performance was a surprise, given persistently weak business confidence, with the latest business confidence index suggesting that two thirds of South African businesses view conditions as unsatisfactory, as shown in Figure 6. We think that recent political developments offer the potential to lift business confidence from its depressed state and drive a higher pace of investment spending, although businesses will likely want to see some more concrete progress against state capture and on fiscal consolidation and stabilisation of state-owned companies (SOCs) before they get really excited about South Africa's future. On balance, we forecast fixed investment spending to track sideways in Q4, but then expand at a pace of 1.3% in 2018.

We forecast GDP growth of 1.4% in 2018, but political developments have the potential to torque this forecast in either direction

The outlook for GDP growth as a whole is a complex interplay of the potential upside for business fixed investment spending, a still muted (although not disastrous) outlook for household consumption (with some downside risk), and a depressed picture for government consumption (Figure 22). In the near term, the inventory cycle might help. Notably, overall GDP growth would have been much better in Q3 had it not been for the inventory cycle, where a big inventory drawdown amounted to 0.2 % of GDP, versus an inventory build-up of an equivalent magnitude in the previous quarter. Thus, from a demand-side perspective, the inventory cycle subtracted 1.5 percentage points from the Q3 growth print. On balance, we forecast GDP growth of 1.5% q/q saar in Q4, to deliver 0.9% for 2017 as a whole. Our macroeconomic model produced a forecast of 1.4% and 1.7% for 2018 and 2019, respectively. We can see risks, both upside and downside, to these projected GDP outcomes. A major politics-related surge in business confidence is the main upside risk, in our view. A sudden unexpected shock, perhaps from a political event or payment difficulties at a state-owned company or the reappearance of drought are all potential sources of concern. And of course there are a number of global risks that that could impact negatively on South Africa.

FIGURE 21

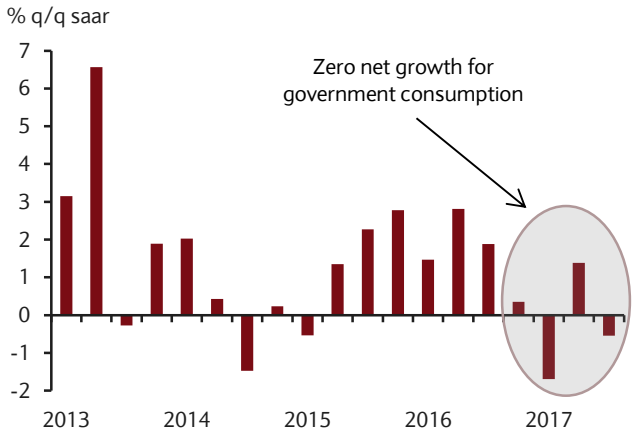
Big rebound in private sector fixed investment in Q3…



Source: Statistics South Africa, Absa Research

FIGURE 22

…but government consumption spending is stagnant



Source: Statistics South Africa, Absa Research

CPI inflation is likely to bottom out soon but upside risks have abated

Consumer price inflation has dipped to the midpoint of the SARB's target range in November, and meat price inflation seems to have peaked

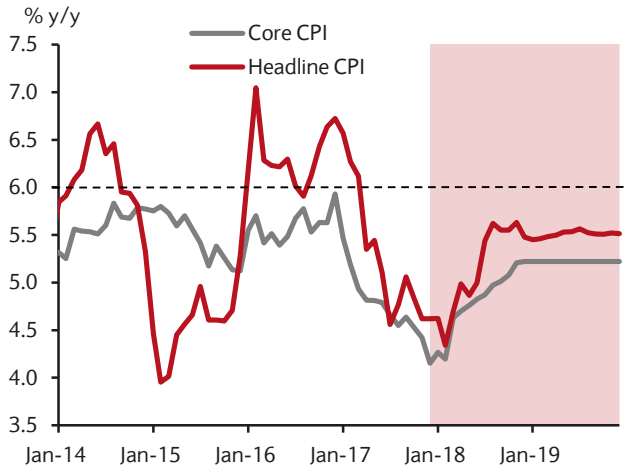
Over the past year, headline CPI inflation has eased close to the mid-point of the SARB's target range, hitting 4.6% y/y in November, compared to a cyclical peak of 6.7% in December 2016 (Figure 23). Lower food prices (17.2% of the CPI basket) have been the major driver of this decline, with food CPI inflation more than halving from a post-drought peak of 11.7% y/y in December 2016 to 5.2% y/y in November (Figure 24). Positively meat price inflation (the price dynamics of which lag those of other drought-sensitive foodstuffs) appears to have reached its peak, having slowed for the second consecutive month in November to 14.9% y/y (Figure 25). Base effects working through food prices and petrol should help to deliver lower CPI inflation over the next couple of months. Overall, we think there may be one or two more months of slightly lower CPI prints, with headline CPI actually coming below the mid-point of the SARB's target range to bottom out at 4.0% in February. Thereafter, we think CPI will accelerate gradually again, given some acceleration of demand, and base effects working through food and petrol prices. The pace and magnitude of this reversal in the remainder of 2018, however, remains highly uncertain.

Core CPI has also eased but the dynamics driving core goods CPI lower are probably quite different to those affecting core services CPI

Notably the decline in headline CPI inflation has also owed something to lower core CPI inflation (Figure 23), with a number of major downside surprises in core CPI at the beginning of the year (Figure 26). We feel there are considerable differences in the dynamics driving the inflation trends for core goods (basically all goods in the CPI basket except for food and beverages and fuel) and core services, which are basically all services except for electricity (Figure 27). Core services seem much more driven by wages and productivity as they manifest in unit labour costs, as well as regulatory developments (Figure 28). By our calculations, core services inflation, which accounts for 61% of core CPI, has been sticky at around 5.5% y/y for several years. In contrast, core goods, which accounts for 39% of core CPI, has declined markedly from 5.6% y/y at the start of 2017 to just 2.9% y/y in November. Of course, inflation expectations play into both. In this regard, there was some welcome news in Q3, when the Bureau for Economic Research found that long-run inflation expectations have abated sharply (Figure 29), although it remains to be seen if the benign Q3 print will have been sustained when the Q4 survey is released on 28 January. Negatively, however, the prices paid index in Absa's PMI survey shows some evidence of accelerating prices pressures in recent months, which could suggest that recent progress on core goods inflation is in danger of reversing (Figure 30).

FIGURE 23

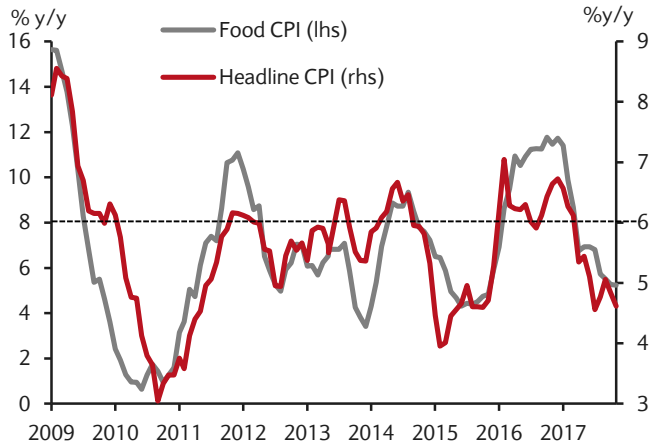
Big decline in headline CPI during 2017 is near bottom now



Source: Statistics South Africa, Absa Research

FIGURE 24

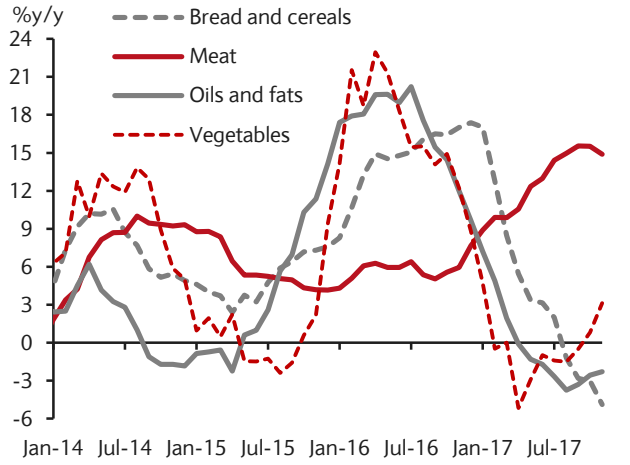
Food price inflation drives the broad brush CPI trends



Source: Statistics South Africa, Absa Research

FIGURE 25

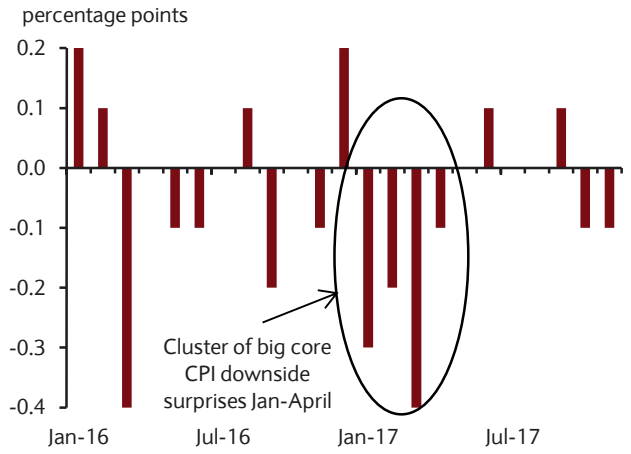
Meat price inflation appears to have topped out



Source: Statistics South Africa, Absa Research

FIGURE 26

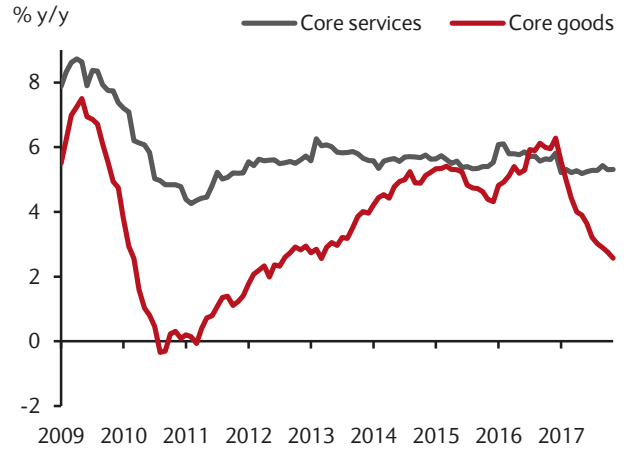
Two recent small core CPI downside surprises



Source: Bloomberg, Statistics South Africa, Absa Research

FIGURE 27

Core services inflation has fallen, but not core services CPI



Source: Statistics South Africa, Absa Research

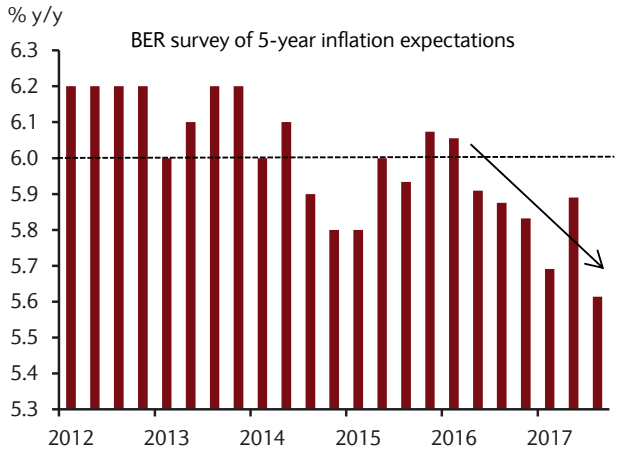
FIGURE 28

Unit labour cost growth remains relatively high

Source: SARB, Absa Research

FIGURE 29

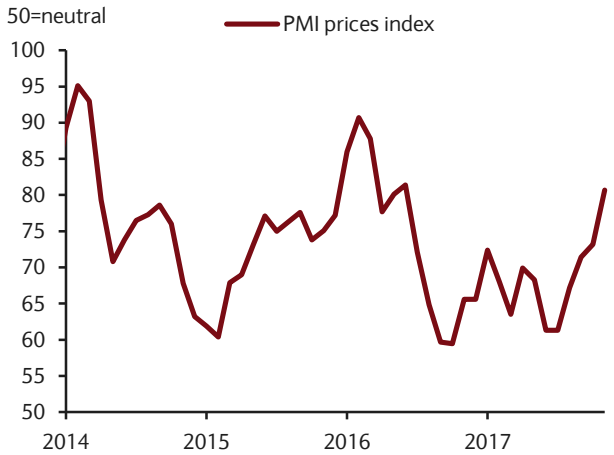
Long-run inflation expectations hit record low in Q3…



Source: Bureau for Economic Research, Absa Research

FIGURE 30

…but PMI index recently points to upward price pressure



Source: Bureau for Economic Research, Absa Research

The currency presently looks to be a downside risk for the inflation trajectory, but we do not forecast the rand's current strength to last

The future trajectory of inflation is encumbered by a variety of upside and downside risks, the balance of which is nearly impossible to calculate with any great confidence. For example, we previously saw mainly upside risk to our projected inflation trajectory from the possibility of a sharp lurch weaker for the rand if the market did not like the outcome of the ANC's electoral conference. However, the 10.5% appreciation of the rand versus the US dollar since the previous MPC will exert downward pressure on CPI inflation, most notably through its impact on petrol prices – for as long as the current rand strength lasts. As we discuss later, we expect the rand to weaken from current levels over the course of 2018.

Regulator awarded Eskom a much lower than expected standard electricity tariff adjustment for 2018, with downside implications for CPI, but there is still uncertainty about how it will play out

Additionally, we no longer see big upside risks on electricity prices, which account for 3.8% of the CPI basket. In our previous *Quarterly Perspectives* we had assumed a 12% residential tariff increase in July 2018, but saw upside risk to this assumption, given our view that there was little of Eskom's application for a 19.9% standard tariff increase (which would have implied a municipal tariff increase of 27% or so) that the National Energy Regulator of South Africa (NERSA) could reject. However, in mid-December NERSA surprised with an announcement that it would allow Eskom to hike its standard tariff by only 5.23% in contrast to the increase of nearly 20% that Eskom had been seeking. (A standard tariff hike of this magnitude would imply a municipal tariff increase of around 7% according to the Eskom Retail Tariff Structural Adjustment methodology (under which Eskom has to recoup all the allowed revenue from municipalities with its own each financial year), lower than our 12% assumption and the 8% that the SARB has assumed in its inflation modelling. Adjusting our electricity price assumption to 7% in July 2018 shaves 0.2 percentage points directly off our CPI profile forecast for mid-2018 to mid-2019. The year following, of course, is another matter entirely. And we have to acknowledge that there is potentially still some upside risk for our 7% tariff assumption for 2019 if NERSA is able to process large pending applications for cost-recovering tariff hikes through the Regulatory Clearing Account mechanism in time for the March tariff adjustment processes to commence, but it is unclear when NERSA will rule on this, or how much of Eskom's request it will grant. For the 2019 year a fresh and lengthier MYPD process will kick in. We had assumed a 6% municipal (ie retail) tariff hike for mid-2019, but are now nudging this up to 8%.

Free university education could have a big impact on the CPI, but there are too many uncertainties at the moment to calculate how much or when

We also now discern a fresh downside risk for the CPI trajectory. President Zuma's surprise announcement at the ANC National Conference that the government will move forward with free tertiary education for poor and working class university students will have big implications for CPI, though the exact modalities and its timing remain unclear. With a weight of nearly 1% in the CPI, a sudden move to free university education for all would lead to one percentage point decline in CPI inflation. However, the reality is likely to be more complex than this simple calculation suggests. Most importantly, it is only a move to free education for those students whose families earn less than ZAR350,000 per year, and on 5 January the Business Day reported the Minister of Higher Education as saying that it would only be phased in over five years. Thus, there is very little clarity about when and how free university education will impact the CPI.

However, prospective tax policy changes and possible return of drought are upside CPI risks

However, we recognize new upside CPI risks as well: a possible VAT hike or introduction of VAT on fuel sales and the early indications of drought in key maize producing areas which could push up maize prices. In particular, National Treasury is desperate for revenue, and the last Budget mooted the idea of introducing VAT on fuel sales. If implemented in April 2018 without any offsetting drop in the fuel levy, it would push up petrol prices by close to 15% m/m, as opposed to the current 1.4% assumption in our model based on 25c/l fuel levy hike. With petrol accounting for 3.8% of the CPI basket, applying the 14% VAT to fuel sales would directly add 0.5 percentage points onto CPI. Furthermore, climatic conditions in December and January so far have been very adverse in South Africa's key maize producing areas, causing farmers to curtail their plantings. The plentiful stockpiles built up in the last bumper season should mitigate price increases somewhat, but even so grain prices might now pose an upside risk for the CPI outlook.

Headline CPI inflation is likely to rise gradually from Q2 18, reaching 5.1% by year-end

Overall, we think that CPI inflation will remain within the SARB's target range over the foreseeable future. With signs that meat price inflation may have peaked, we expect food price inflation to fall further to below 4% in Q1 18 before rising gradually as base effects fade. We see food price inflation rising to about 5.1% y/y by year-end. We expect core CPI inflation to ease further to reach a low point of 4.2% y/y in December but see it trending higher from Q2 18 amid a narrower output gap and still elevated unit labour costs. With recent petrol price over-recoveries, this leaves our forecast for headline CPI inflation falling further in the short term to reach point of 4.0% y/y in February 2018. Thereafter, we expect headline CPI inflation to rise gradually, reaching 5.1% y/y y the end of 2018.

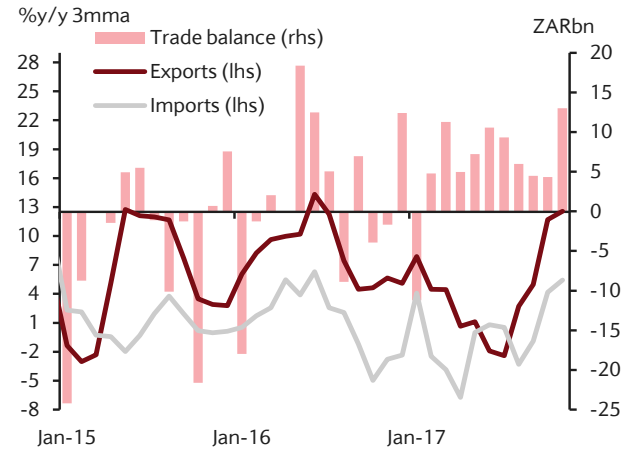
Solid improvement in external accounts

Exports of iron ore and steel to China appear to have risen markedly in 2017, delivering a much bigger than expected trade surplus in November

South Africa's external payments situation improved markedly over the course of 2017 in a way that we did not really expect in 2016. The latest monthly merchandise trade data for November showed a much bigger than expected trade surplus of ZAR13.0bn in November, with export growth (12.6% y/y 3mma) continuing to outpace import growth (5.4% y/y 3mma) by quite a significant margin (Figure 31). The end of the drought in most of the country (although not the wheat producing areas in the Western Cape) is playing a role here. Net exports of maize returned to surplus in 2017, after a big deficit in late 2015 and 2016 (Figure 32) although the magnitude of the effect is small relative to South Africa's overall trade volumes. And while imports of crude oil and refined petroleum products are running at roughly the same pace as 2016, exports of iron ore and coal have risen this year (Figure 33) as has South Africa's net trade surplus in steel and other basic metal products. Much of these increased exports of iron ore, steel and coal appears to be going to China, with South Africa's exports to China hitting an all time high (in rand, though not dollar, terms) in November (Figure 34). Part of the explanation is terms of trade gains, with 2017 sustaining a material advantage in terms of trade compared to the previous couple of years (Figure 35). Coal prices in particular have shot up recently (Figure 3). Nonetheless, the trade surplus, which is the tenth consecutive one this year, and the largest since May 2016, is all the more remarkable because there is a clear seasonal pattern which typically sees November post weak trade balances.

FIGURE 31

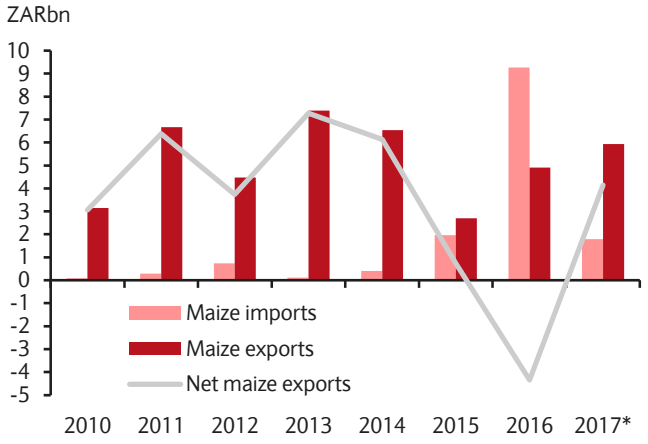
Exports grow faster than imports; surpluses mount



Source: SARS, Absa Research

FIGURE 32

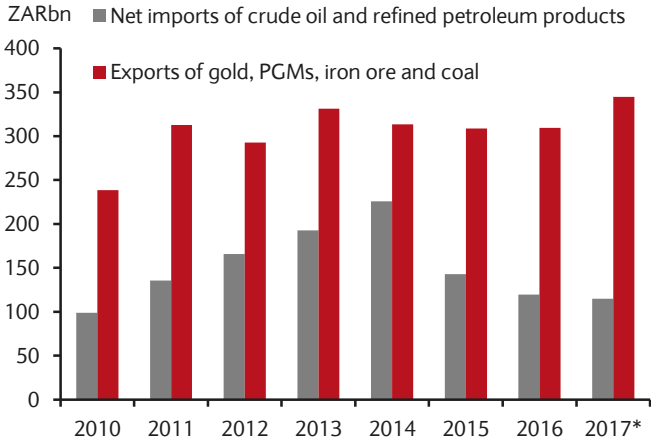
Trade in maize moved back into surplus in 2017



* Jan-Nov only. Source: SARS, Absa Research

FIGURE 33

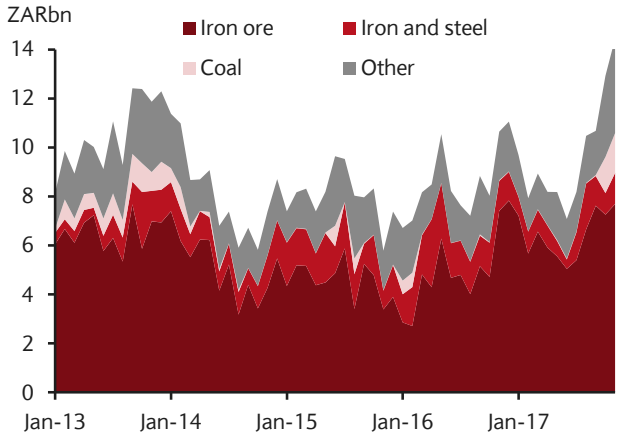
Net balance of trade in minerals has improved a lot in 2017



* Jan-Nov only. Source: SARS, Absa Research

FIGURE 34

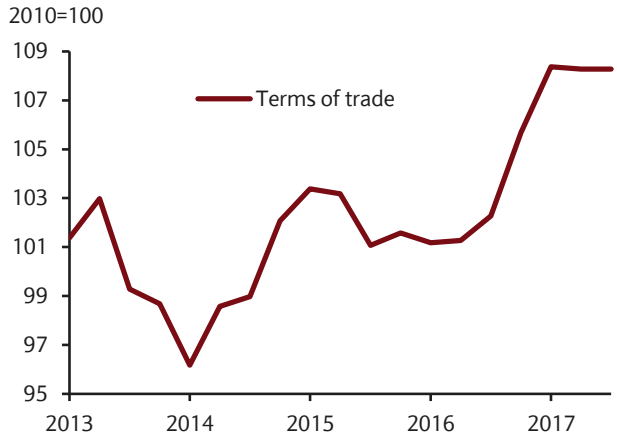
Rand value of exports to China hit an all time high in Nov.



Source: SARS, Absa Research

FIGURE 35

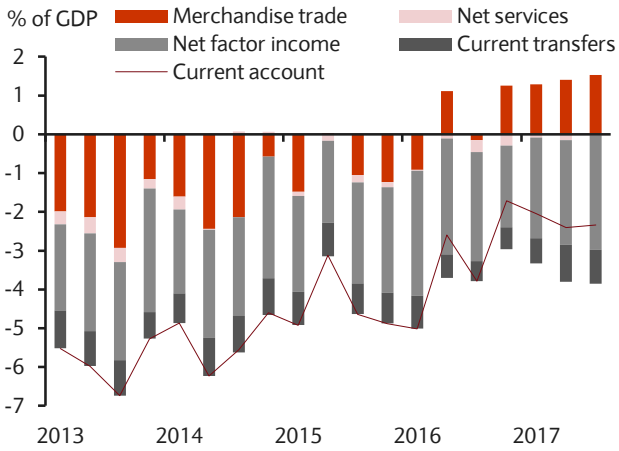
Terms of trade have sustained a big improvement in 2017



Source: SARB, Absa Research

FIGURE 36

Narrower CA deficit due to merchandise trade surplus…



Source: SARB, Absa Research

The current account deficit has shriveled

On current trends, South Africa's current account deficit in Q4 could materially undershoot even the 2.3% of GDP posted in the third quarter (Figure 36). Indeed, if the seasonally adjusted merchandise trade performance in October and November is sustained into December, then the annualised quarterly merchandise trade surplus would have improved by 0.9% of GDP between Q3 17 and Q4 17, thereby significantly offsetting the big rise in the deficit in income payments due to higher interest rate outflows (Figure 37). Fortunately, net dividend outflows appear fairly stable (Figure 38). We forecast a current account deficit of 1.4% of GDP (seasonally adjusted) for Q4 17, which would deliver 2.0% of GDP for the whole of 2017. We think it will widen out slightly in 2018 to 2.3% of GDP due to higher import demand, especially if business investment picks up. Higher-than-expected crude oil prices would seem to be an adverse risk for our current account deficit forecast. We acknowledge some merit in the argument that for some analytical purposes South Africa's current account balance should be adjusted to strip out the effects of transfers to the other countries in the Southern African Customs Union (SACU) since these are settled in rand. South Africa's government net transfers amounted to 1.2% of GDP seasonally adjusted in Q3 17.

Portfolio capital inflows were significantly negative in the three months to November but could turn around if December's political developments play out positively

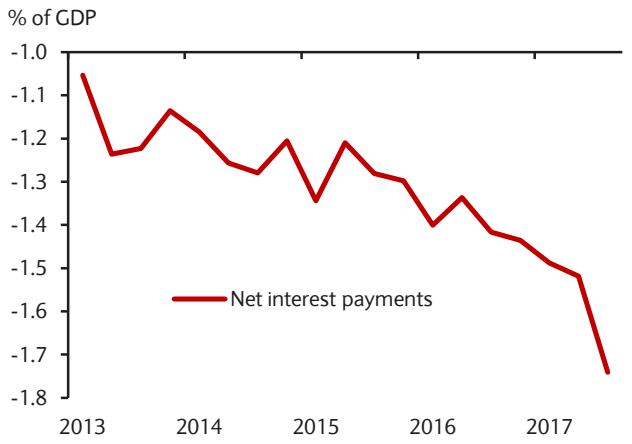
Of course, with a significant degree of foreign participation in South Africa's domestic capital markets and a relatively open capital account, any assessment of the balance of payments must also examine the picture on capital flows. Portfolio capital flows were moderately negative in the run-up to the ANC's electoral contest (Figure 39), but new optimism about South Africa's future in the wake of Deputy President Cyril Ramaphosa's election as ANC president may serve to turn those around in late December and January, when fund managers return to work. Certainly, the strength of the rand since the conference closed suggests some inflows although markets are exceptionally thin at this time of year. Notably, as well, unidentified FX flows – as measured by the errors and omissions balancing line in the balance of payments – were over 2% of GDP in Q3 (Figure 40).

South Africa's positive net international investment position hit a record ZAR1trn at the end of Q3 17

Any examination of a country's external balances should also look stock positions, as well as flows. Unusually amongst developing countries, despite big foreign portfolio investment in our domestic equity and bond markets, South Africa runs a positive net international investment position (IIP), due to major direct and portfolio investments abroad by South African individuals and corporates. Little noted because the SARB released the data on 29 December, South Africa's IIP strengthened dramatically over Q3 17 to ZAR1060bn (about 23% of GDP) from ZAR656 at the end of Q2 17. This was due mainly to a big rise in South Africa's foreign assets, which has outstripped the growth in foreign liabilities, due partly to

FIGURE 37

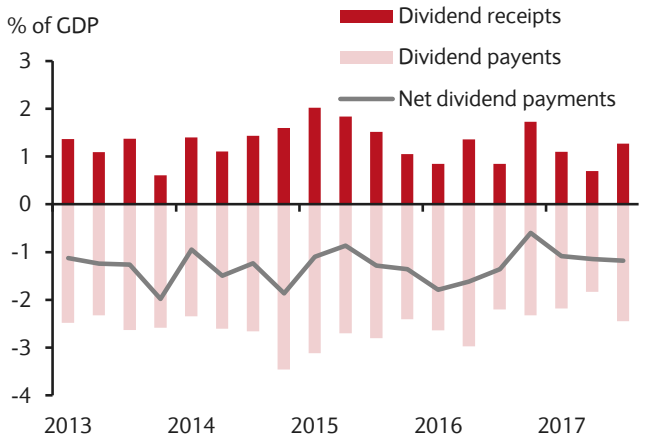
…despite sharply higher net outflows of interest payments



Source: SARB, Absa Research

FIGURE 38

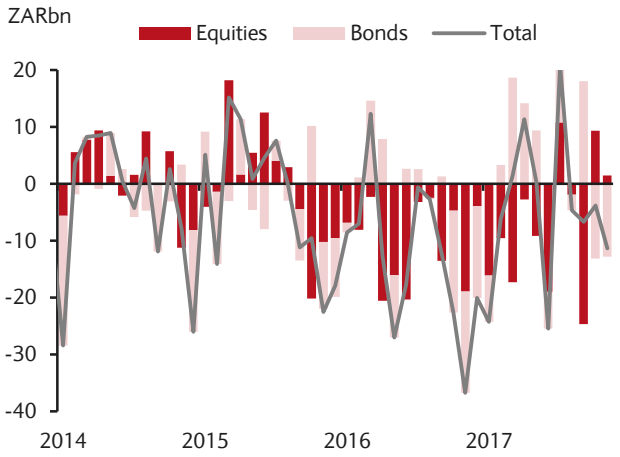
Net dividend outflows appear fairly stable



Source: SARB, Absa Research

FIGURE 39

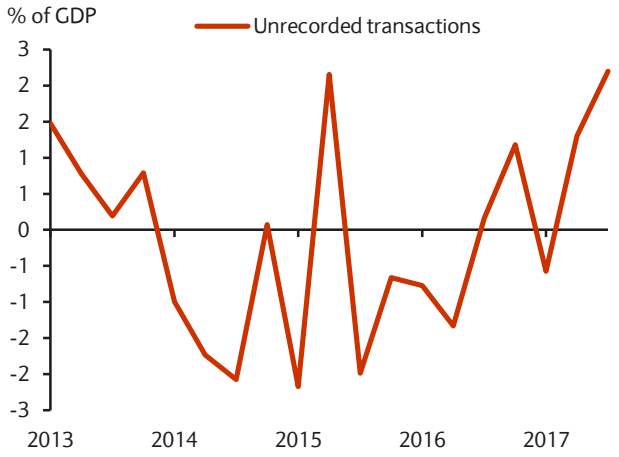
Big net portfolio outflows ahead of ANC conference



Source: SARB, Absa Research

FIGURE 40

…but unrecorded transactions have been large and positive



Source: SARB, Absa Research

valuation effects from rising global equity markets and the 4.6% depreciation of the rand in Q3 17. However the SARB also pointed to a "purchase by domestic telecommunications company of a controlling stake in a company abroad" as a contributing factor. Of course the strengthening of the rand exchange rate over Q4 17 will work against the IIP when the Q4 data are published at the end of March, but regardless the data are still a positive for the South African macro narrative.

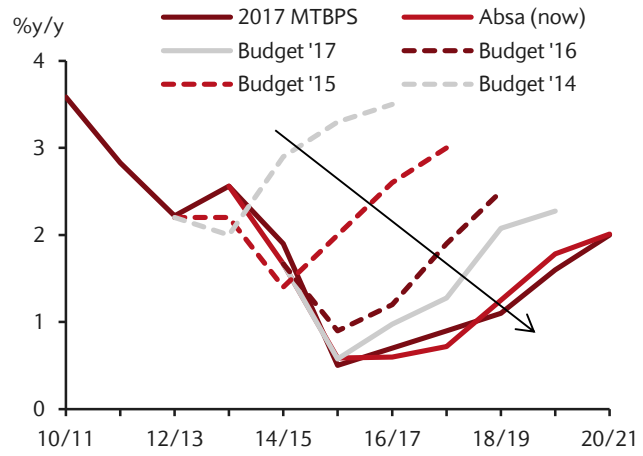
Filling South Africa's gaping fiscal hole will not be easy

A big tax revenue shortfall means that the main budget deficit is likely to hit 4.7% of GDP this year

South Africa's fiscal imbalances are a significant problem that will not be easy to solve, even for the most committed of governments. Finance Minister Gigaba announced in the Medium-Term Budget Policy Statement in mid-October that the revenue shortfall compared to original 2017/18 Budget targets would amount to nearly ZAR51bn – over 1% of GDP. The revenue shortfall seems due to a tricky combination of much slower than expected growth (Figure 41) and – especially worrying – a big decline in tax buoyancy (Figure 42). The latter could be driven by institutional problems at South African Revenue Services, declining corporate and personal tax morality, and a possible pick-up in emigration of high net worth individuals. As a consequence, the government now projects the consolidated fiscal deficit to come in at 4.3% of GDP, compared to an original target of 3.1% of GDP. The main budget deficit, which excludes the financial positions of provinces, social security funds and extrabudgetary institutions, is now forecast at 4.7% of GDP this year, compared to the 3.5% of GDP projection produced in the most recent budget document (Figure 43). The primary main budget balance no longer is envisaged to turn to surplus over the course of the planning horizon (Figure 44). Regrettably, no sudden salvation has emerged since the MTBPS. Main budget fiscal data for November show tax revenue growth of just 5.4% y/y, although expenditure growth also seemed well contained at 4.5% y/y. But the main budget fiscal deficit of ZAR15.3bn in November, coming hard on the heels of October's ZAR34.8bn pushed the cumulative main budget deficit for the year as a whole to ZAR195.1bn, compared to a revised target of ZAR219.6bn for 2017/18 as a whole. However, December is a key month for both personal and corporate income tax receipts, and the preliminary government financing data suggests a main budget surplus of around ZAR30bn, which is better than the ZAR22.7bn surplus in December 2016. However, for various technical reasons (timing of payment flows etc) the financing data are not always a perfect guide to the budget balance.

FIGURE 41

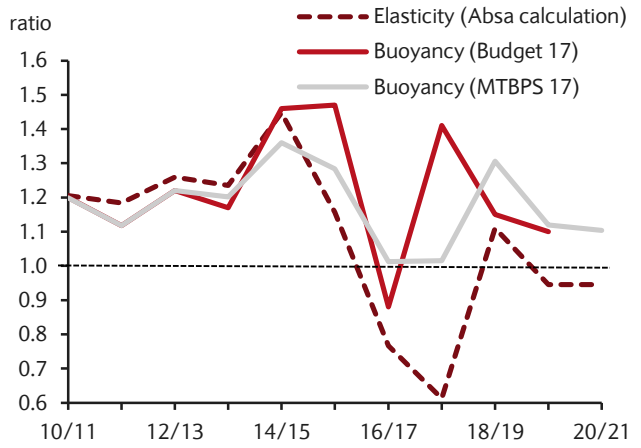
Persistent GDP disappointments undermined the fiscus



Source: National Treasury, Absa Research

FIGURE 42

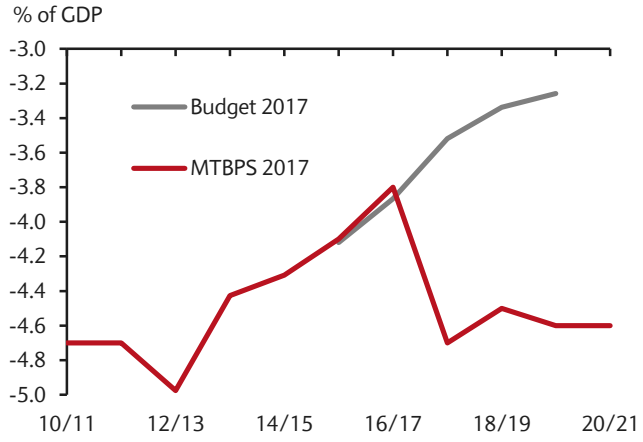
But tax elasticity has shriveled too



Source: National Treasury, Absa Research

FIGURE 43

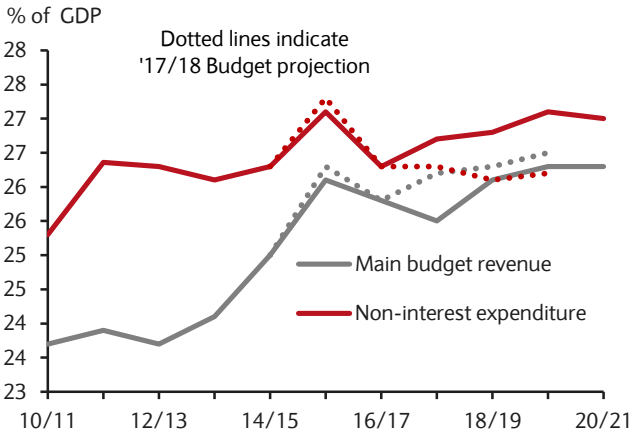
MTBPS projected a sharply wider main budget deficit…



Source: National Treasury, Absa Research

FIGURE 44

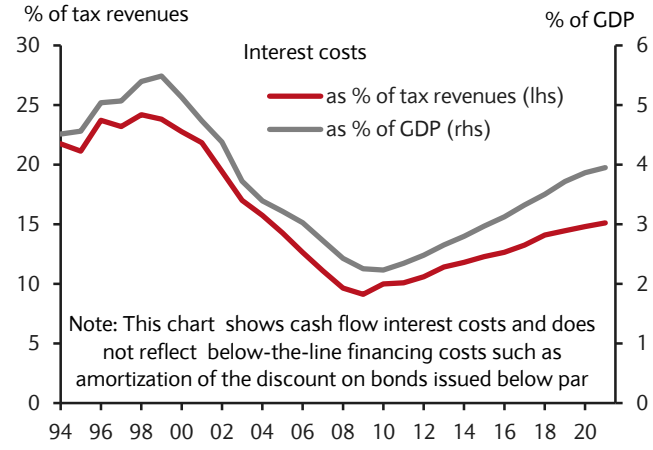
…with continued primary deficits



Source: National Treasury, Absa Research

FIGURE 45

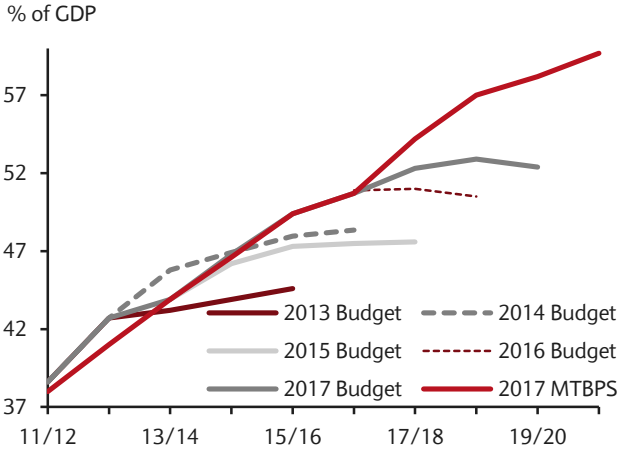
Debt servicing burden is rising steadily



Source: National Treasury, Absa Research

FIGURE 46

Treasury no longer projects the debt ratio to stabilise



Source: National Treasury, Absa Research

South Africa faces some tricky debt dynamics, with debt to GDP unlikely to stabilise without further tough consolidation measures

With real interest rates that are well in excess of the real growth rate of the economy, and few non-debt sources of financing given the government's ideological aversion to the idea of privatisation, the simple inexorable arithmetic of debt dynamics is adverse. Interest costs are now the most rapidly growing part of the government budget, amounting to 3.5% of GDP or 14 cents for every rand of tax collected (Figure 45). And, notably, in the government's cash-based accounting system, this does not factor in the additional debt costs reflected in the discounts on bonds issued below par. Thus, over the three-year fiscal planning horizon the government's own MTBPS projections no longer show debt-to-GDP rising; instead the government projects it to rise to nearly 60% of GDP by 2020/21 from 50.7% of GDP estimated at the end of FY 16/17 (Figure 46). However, the since the MTBPS, the government has adopted new fiscal plans, so the debt trajectory will undoubtedly be altered when the 2018 Budget is published on 21 February.

SOCs with government guaranteed borrowing are a particular source of fiscal risk – especially Eskom

And this is even before any further crystallisation of the obligations of state-owned companies onto the government's balance sheet. The ongoing financial and operational challenges at Eskom clearly leave a big risk that Treasury might have to step in to avert a big market-roiling default. Just before the seasonal holidays, Eskom deferred reporting its financial results and there has been little information from it or the government directly as to how it will meet the challenge of reduced liquidity levels and a much smaller-than-expected tariff increase. We continue to view the troubling situation at Eskom as one of the key fiscal problems faced by the government, given Eskom's projected ZAR243bn utilisation of National Treasury guarantees by end-2018.

Troubled SAA has already effectively transferred some of its debt problems to the government, but the challenges at SANRAL appear less severe

Already debts of some SOCs are migrating to the government's balance sheet. Notably, the MTBPS announced that the government would breach its own self-imposed expenditure ceiling in 2017/18 by about ZAR4bn due to some ZAR13.7bn bailouts in FY 2017/18 for South African Airways and South African Post Office. However, the immediate funding and financial challenges at the other big SOC user of government guarantees, the South African National Roads Agency Limited (SANRAL), appear less demanding. SANRAL's 2017 annual report noted that guarantees from the government totalled ZAR37.9bn, of which ZAR28.9bn had been utilised at 31 August 2017, and that it should be able to stay within this limit until 2019, with cash requirements until September 2018 amounting to just ZAR2.5bn. If a scheduled bond redemption in November 2018 is included, this would increase to ZAR5.5bn. Overall, however, SOCs, particularly Eskom, remain a big source of fiscal concern. Finance Minister Gigaba's action plan for inclusive growth promised that the government would reduce the usage of state-owned guarantees for SOC borrowing, but has not provided any convincing explanation or plan for weaning the SOCs off this source of fiscal risk.

A sizeable fiscal adjustment effort is seemingly promised for the upcoming fiscal year, but the details are vague

Although the market reacted very negatively to the lack of "a plan" in the MTBPS to address the revenue shortfall, the government did roughly outline some further adjustment steps after S&P downgraded South Africa's sovereign credit rating at end November and Moody's put the country on review for a downgrade. Nevertheless, we believe that if National Treasury had had sufficient political support to put these measures into the MTBPS in the first place then the negative market reaction and negative credit rating actions could potentially have been avoided altogether. Nonetheless, at end-November President Zuma directed the Presidential Fiscal Committee, as "led by Finance Minister Gigaba and the National Treasury" to focus on four areas in preparation for measures in the 2018 Budget.:

- Additional expenditure cuts of ZAR25bn in areas that will not negatively affect growth;
- Revenue increases of ZAR15bn including tax hikes;
- Develop a phased implementation for free university education for poor students, in a fiscally sustainable manner; and
- Identify a package of economic stimulus measures that will spark faster growth.

Growth-boosting measures will be need to counteract the contractionary effect of a big fiscal consolidation package

On top of measures already announced in previous MTBPS's and budgets, the promises listed above made by the government at the end of November would deliver a total fiscal adjustment of about ZAR82bn - nearly 2% of GDP in FY 2018/19 (Figure 47). Promises to adjust are indeed encouraging, but given the scale of the challenge and South Africa's track record of laying well intentioned plans and then disappointing on implementation, markets and rating agencies will likely want to see a very detailed and credible adjustment plan in the upcoming budget. And any fiscal consolidation effort to the tune of ZAR82bn is inevitably going to be quite contractionary and thus to be accompanied by clear, rapid and bold steps on the package of growth boosting measures, such as clarity on the Mining Charter. But for now many of the most important ones here remain mired – for now – in South Africa's complex political situation.

Big there are big upside spending risks from public sector wage negotiations currently underway…

In particular, it is not clear how the government can cut ZAR56bn from spending in 2018/19, especially given that it currently is renegotiating the public sector wage deal which expires in March. The MTBPS penciled in an increase in public sector employee costs of just 7% for FY 2018/19. Unions appear to be in a militant mood, demanding increases of 10-12% as well as increased housing allowances. We think the government may possibly have a little bit of room to manoeuvre given that inflation has fallen, so it is possible the unions could be persuaded to accept a lower nominal increase than the double digit increases they are demanding, but even so it will be hard to get them down to 7%, and this does not even account for the fact near-automatic annual "notch progression" within salary bands and salary bands creates upward drift in the overall salary bill of about 1.5% per year (Figure 48). There is practically no information on how the public sector wage negotiations are proceeding, although at the end of November the unions complained stridently about the government's lackadaisical approach to the negotiations. Absent a focused retrenchment programme (which we think unlikely ahead of the 2019 general elections), we see material upside risk to the fiscal allocation for employee compensation.

…and President Zuma's promise of free university education for nearly all

Moreover, in a surprisingly populist move, President Zuma dramatically intensified the pressures on the spending envelope with his unexpected announcement at the ANC leadership conference – against the advice of the government's own commission of inquiry into higher education and that of National Treasury – that university tuition would be made free for poor and working class students. There is no clarity yet from the government on how or when this policy would be implemented or funded, but we estimate that such a move would cost the government an additional 1% of GDP. Now that the commitment has been given, it would seem very hard for the government to rescind it, and an earlier promise

FIGURE 47

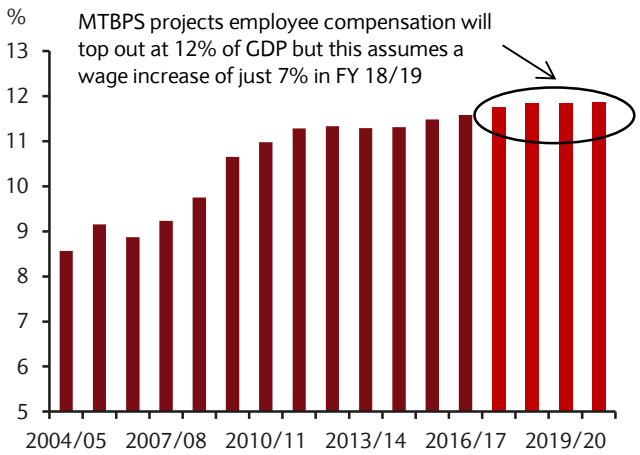
Additional adjustment measures broadly promised

Announced in:	Rbn	15/16	16/17	17/18	18/19
2015 Budget	Spending cuts	10	15	-	-
	Tax hikes	17	-	-	-
2016 Budget	Spending cuts	-	-	10	15
	Tax hikes	-	18	15	15
2017 Budget	Spending cuts	-	-	10	16
	Tax hikes	-	-	13	-
2018 Budget*	Spending cuts	-	-	-	25
	Tax hikes	-	-	-	15
Subtotal	Spending cuts	10	15	20	56
Subtotal	Tax hikes	17	18	28	30
Total	**All**	**27**	**33**	**48**	**86**

* Not yet detailed. Source: National Treasury, Absa Research

FIGURE 48

The growth of the public sector wage bill needs reversing



Source: National Treasury, Absa Research

to implement it in a phased approach seems to have been abandoned. On the other hand, President Zuma's push to implement a costly nuclear power procurement is not likely to progress very far.

More tax hikes and cuts in tax expenditures are likely in the 21 February Budget

We expect the National Treasury to further hike taxes in the upcoming budget. The adjustment measures announced above point to further revenue increases of ZAR32bn in total, but they have not yet been specified. More important than the quantum of any fiscal adjustment, is its actual composition. Further hikes in direct taxes may prove counterproductive, given the observable decline in tax buoyancy. However, a VAT hike would give the market confidence that the government is serious about eliminating fiscal slippage, but implementing a general VAT hike has been anathema to the ANC for some time now. However, in line with an idea mooted in the 2017 Budget, the Treasury could remove the zero rating for VAT on fuel sales (a so called "tax expenditure"). If it implemented this with no offsetting cut in the General Fuel Levy, we calculate it could raise c.ZAR18bn. The Treasury has promised it will also introduce the sugar tax with effect from 1 April, and we think it could raise ZAR5bn, while the government published its carbon tax bill in mid-December. However, it notes that "the carbon tax will be revenue-neutral during its first phase" with revenues recycled (or specifically earmarked for additional measures) to reinforce the primary environmental objectives of the carbon tax. It seems likely that personal income tax collections will be lifted again by incomplete adjustment for fiscal drag, and potentially another increase in the top marginal rate of income tax. We think the National Treasury would be well advised to look to raise revenues by cutting other parts of its "tax expenditures" which totalled 3.6% of GDP in 2014/15 (including the zero rating of VAT on fuel sales), such as the ZAR23.5bn tax breaks (2014/15) for the motor vehicle industry (although we do not expect this). And it seems to be wanting to reserve the elimination of the medical aid tax credits (ZAR18.5bn in FY 2014/15) to help finance the introduction of National Health Insurance. But the zero rating on municipal property rates (worth ZAR10.5bn in 2014/15) might be an attractive target.

If Ramaphosa is able to secure the early exit of Jacob Zuma, the resulting cabinet reshuffle could see Zweli Mkhize appointed as Finance Minister

Clearly, a lot is riding on the upcoming budget on 21 February, and yet uncertainties abound. It is not even clear whether Finance Minister Gigaba will still be at the helm in February. As we have noted above, an early recall of President Zuma would likely be accompanied by wholesale changes in cabinet as well, once parliament elects the new state president (presumably Ramaphosa). Zweli Mkhize, who was the ANC's Treasurer-General in the last leadership collective and who topped the list of officials elected to the National Executive Committee seems a likely shoe-in for the next Finance Minister. By the time the political issues are resolved, however, the National Treasury will already have had to complete most of the work on the budget programming, so it unclear how much change a new minister could make at the last minute.

We think Moody's is more likely than not to downgrade South Africa

Overall, it is the pending political changes – or ultimate lack thereof – and how such changes filter through into fiscal settings and other key policies (such as those pertaining to state-owned companies) – that will determine South Africa's credit ratings trajectories in 2018. Both Fitch and S&P have now got South Africa's credit ratings in sub-investment grade territory on a Stable Outlook and we think the ratings are likely to stay there for some time. Moody's put South Africa on review for a downgrade following its jarring MTBPS, and then issued a statement in the wake of the ANC's conference saying that while Ramaphosa's election was potentially "credit positive", the split in the leadership positions between the two factions could continue to compromise policy making. On balance, we think that it is more likely than not that Moody's follows through with a downgrade of its Baa3 Negative Outlook ratings, once it has assessed the 2018 Budget – unless Ramaphosa can demonstrate some pretty quick and big political and policy wins. The fiscal imbalances and policy challenges are just too big, we think, for Moody's not to downgrade, no matter how much confidence it may have in Ramaphosa.

Monetary policy: on hold for the foreseeable future

SARB's assessment of the balance of risks to the inflation outlook at the 18 January MPC will reveal much about how it views the new array of facts and market variables in South Africa

Inevitably, the uncertainty around the inflation outlook for 2018 also implies uncertainty around the path for monetary policy. We now think inflation is likely to track inside the SARB's target range for the foreseeable future, and that risks which we previously saw as lying predominantly to the upside are now much more evenly balanced, if not even tilted slightly to the downside. It will be interesting to see if the SARB also changes its tune at the next Monetary Policy Committee statement on 18 January, after having in November described the risks to its forecasts as being titled to the upside amidst "particularly elevated uncertainty" regarding key event risks. Regardless of its assessment of the balance of risks, however, we do not think the SARB will be in a rush to cut, with the 25bp July interest rate cut (which was only narrowly decided in a 4:2 vote) having come against the backdrop of exceptionally weak confidence and a markedly weak Q1 GDP data print that had confirmed the country was in recession. (We remind that the September MPC was a 3:3 vote to stay on hold while the November MPC, coming just ahead of key credit rating reviews and the ANC's electoral conference, was a unanimous decision to stay on hold.)

We do not see the SARB being in any great rush to ease

Admittedly some of the big event risks have come and gone, with a relatively benign market assessment of their outcome, judging from the rand's 10.5% appreciation (in trade-weighted terms) since the most recent MPC. But despite the market's relatively benign assessment as reflected in the rand's behaviour (helped perhaps by recently favourable inflation news) we think the SARB would prefer to "book" these positive developments as further progress in the long-term downward adjustment of CPI inflation and inflation expectations. For one thing, the SARB MPC will likely conclude that there is no compelling need to cut, given that the economy is growing again, albeit modestly. The MPC has also openly stated that it will look through the first-round effects of any rand appreciation especially since it is highly conscious of the volatility in the currency, always aware that the rand's movements today could be reversed tomorrow. And worryingly large fiscal imbalances persist with potential consequences for further credit rating downgrades in 2018. The SARB MPC itself has said that it still views monetary policy settings to be accommodative. As a baseline, therefore we expect the SARB MPC to remain cautious and keep the repo rate unchanged for the foreseeable future. This is also the consensus view as represented by the median forecast of economists polled by Reuters in January.

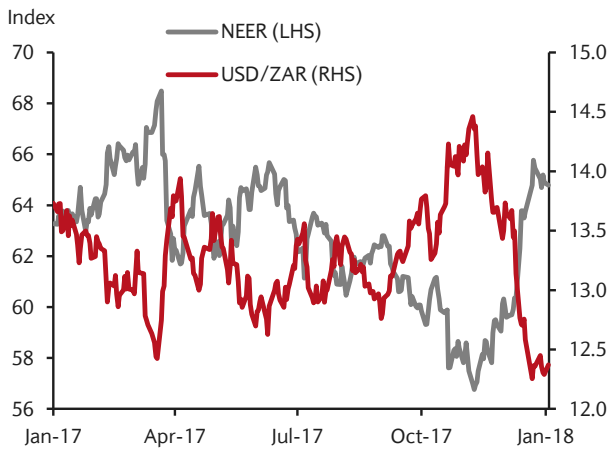
Exchange rate is likely to weaken after post-ANC conference rally

We expect the ZAR to surrender some of its post-ANC conference gains partly because of global factors and partly because of domestic concerns

We retain a somewhat bearish view on the rand. We think the ZAR is vulnerable to monetary policy normalisation in the US and Europe, while the upside potential for commodity prices also seems limited due to Chinese weakness and the prospect of a firmer USD from a more hawkish Fed and the pro-growth corporate tax relief measures. Domestically, we expect GDP growth to remain soft in the near term and there is still also the lingering threat of a credit rating downgrade from Moody's to sub-investment grade, which could obligate a number of passive foreign bond investors that track the World Government Bond Index to sell about $8bn worth of SAGBs. We forecast USDZAR at 13.80 by the end of Q1 18 and at 14.10 by the end of 2018. We acknowledge a big risk to our bearish ZAR view from continued large capital inflows into emerging markets in general as investors continue to hunt for yield in an environment of strong risk appetite (especially if fuelled by further evidence of a broad-based global economic recovery). Also, given that the market is currently discounting policy rate cuts from the SARB over the coming months, if realised, our forecast that policy rates remain on hold might work against our forecast of ZAR weakness.

FIGURE 49

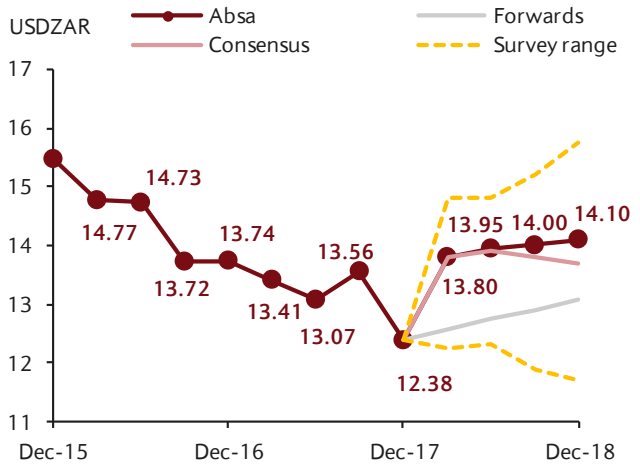
Rand has strengthened over 10% since the last MPC



Source: Thompson Reuters, Absa Research

FIGURE 50

Our rand view is a bit more bearish than consensus



Source: Bloomberg, Absa Research

This macroeconomic forecast has more uncertainty than usual

Economy is doing OK and should respond positively to political change, but it remains unclear just how quickly or how far political change will materialise

Absa's official forecasts are presented in Figure 51, and the key domestic and international assumptions that underpin our forecast in Figure 52. We now expect GDP growth in 2018 of 1.4%, up 0.3 percentage points from the previously Quarterly Perspectives forecast for 2018 GDP growth. Our forecast for 2019 is unchanged at 1.7%. We now have a more subdued inflation forecast compared to the last Quarterly Perspectives, with CPI forecast to average 4.8% this year and 5.5% next year (previously 5.4% and 5.7% respectively). However, there are a greater than usual number of both upside and downside risks to our current forecast CPI trajectory, as we have previously elaborated. The current account deficit is now forecast at 2.3% of GDP in 2018 and 2.9% of GDP in 2019, again better than the previous Quarter Perspective forecasts 3.0% of GDP and 3.4% of GDP respectively.

An alternative forecast scenario, run with a stronger exchange rate assumption, shows material deviations from the baseline forecast

The forecasting exercise is difficult. The future is fraught with uncertainty even in the most predictable of countries with ultra stable politics and policies, and South Africa is far from that. Moreover, various key market variables – such as oil prices and the exchange rate – are notoriously difficult to predict with great accuracy, and yet they are absolutely critical to various facets of macroeconomic performance. For example, to take just one example, the Reuters consensus forecasts for crude oil prices embedded into our forecasts are fairly flat (Figure 52). Current spot prices might hint at big upside risks to our assumptions with adverse implications for both our inflation forecast and our balance of payments projections. Similarly, in any macroeconomic forecast, the exchange rate assumption is absolutely central, with a key role in many of the model's constituent equations, and affecting nearly every part of model output. We have run an alternative scenario under which the real effective exchange rate, instead of depreciating about 3% in each of 2018 and 2019 which is our baseline assumption, stays constant. This alternative model run produces quite significant deviations from the baseline, which we tabulate in Figure 53.

FIGURE 51

Our baseline macroeconomic forecast: stronger than the last Quarterly Perspectives except on the fiscal front

	2017		2018				2019									
	Q3	Q4	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F	2016	2017	2018F	2019F	2020F	2021F
Output (% q/q saar)																
Real GDP	2.0	1.5	1.1	1.0	1.2	1.2	1.7	2.1	2.5	2.6	0.3	0.9	1.4	1.7	1.9	1.9
Real GDP (%y/y)	1.0	1.4	1.8	1.4	1.2	1.1	1.3	1.6	1.9	2.2	0.3	0.9	1.4	1.7	1.9	1.9
Household consumption	2.6	0.8	0.8	0.8	0.9	1.1	1.2	2.5	2.7	3.2	0.8	1.3	1.3	1.7	2.0	1.9
Durable goods	19.9	1.3	0.8	0.5	1.2	2.0	3.2	4.8	4.8	5.4	-7.3	0.6	3.5	3.2	3.7	3.5
Semi-durable goods	4.4	4.9	0.1	0.2	0.1	1.0	2.9	2.6	3.0	3.2	3.3	2.4	2.8	2.0	3.1	3.1
Non-durable goods	0.3	0.4	0.8	0.9	1.0	1.1	0.8	1.9	2.6	2.6	0.9	0.5	1.1	1.4	1.6	1.4
Services	1.0	0.2	1.0	0.9	1.0	1.0	0.8	2.5	2.2	3.2	2.1	1.9	0.8	1.5	1.7	1.8
Public consumption	-0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	2.0	0.3	0.4	0.5	0.5	0.5
Investment	4.3	-0.1	0.9	1.5	1.8	2.1	2.5	3.3	3.4	4.5	-3.9	0.2	1.3	2.7	3.2	3.3
Exports	-10.3	3.8	3.4	2.7	4.3	1.9	2.4	1.2	1.9	0.4	-0.1	0.8	2.2	2.1	1.7	1.8
Imports	-13.7	3.2	2.2	2.4	3.8	2.4	1.4	2.2	1.9	1.5	-3.7	1.9	1.1	2.2	2.1	1.9
External and government accounts (% of GDP)																
Current account	-2.3	-1.4	-2.1	-2.2	-2.2	-2.6	-2.8	-2.8	-2.8	-3.1	-3.3	-2.0	-2.3	-2.9	-3.3	-3.7
Consolidated fiscal balance*	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	-3.3	-4.3	-3.3	-3.2	-3.0	-2.9
Consolidated primary balance*	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	0.0	-0.8	0.4	0.6	0.9	1.0
Government debt*	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	50.7	54.2	56.4	57.5	58.5	59.4
Prices (% y/y)																
CPI inflation	4.8	4.7	4.3	4.6	5.1	5.1	5.3	5.5	5.5	5.5	6.3	5.3	4.8	5.5	5.5	5.7
Core CPI inflation	4.6	4.4	4.4	4.8	5.0	5.2	5.2	5.2	5.2	5.2	5.6	4.8	4.9	5.2	5.4	5.6
PPI inflation	4.3	4.9	4.9	5.0	5.2	5.0	4.6	5.3	5.2	5.2	7.1	4.8	5.0	5.1	5.4	5.1
Interest rates (% eop)																
Repurchase rate	6.75	6.75	6.75	6.75	6.75	6.75	6.75	6.75	6.75	6.75	7.00	6.75	6.75	6.75	6.75	6.75
Prime rate	10.25	10.25	10.25	10.25	10.25	10.25	10.25	10.25	10.25	10.25	10.50	10.25	10.25	10.25	10.25	10.25

* Fiscal year starting April. Source: Reuters, SARB, Statistics South Africa, National Treasury, Absa Research

FIGURE 52

Our assumptions differ from the SARB's in some key respects

Variable	Absa assumption	SARB assumption (Nov MPC)	General comments and risks to our assumptions
Key Global Economic Assumptions:			
Global growth	G7 growth of 2.1% and 1.8% in 2018 and 2019 respectively. China growth of 6.5% and 6.3% in 2018 and 2019 respectively.	Growth of SA's main trading partners is projected to be 3.4% in 2018 and again in 2019.	Absa's and SARB's global growth assumptions for model inputs are not strictly comparable. The world economy continues to pick up moderately but the rest of Africa, which absorbs roughly half of South Africa's exports of manufactures, is still relatively weak.
Brent crude	Using Bloomberg consensus forecasts as a base we forecast Brent at $57/bbl and $62/bbl in 2018 and 2019, respectively.	Brent averages $57/bbl and $58/bbl in 2018 and 2019, respectively.	The Brent spot price has risen sharply in recent months to hit close to $70/bbl. However, US shale production could come back on stream soon to push prices down again but the risk is that they do not ease as much or as quickly as expected.
Nonoil commodity prices	We use Bloomberg consensus forecasts for 2018-19 as a base: Gold in $/oz at 1268 and 1300; Platinum in $/oz at 994 and 1100; Coal at $/mt 65 and 64; Iron ore in $/mt at 59 and 57.	SARB does not reveal any specific commodity price assumptions. Instead it assumes international commodity prices rise by 2.0% in 2018 and 1.5% in 2019.	Absa and SARB commodity price assumptions are not strictly comparable. The Bloomberg consensus forecasts suggest that coal and iron ore prices will trend lower from current spot prices and remain relatively flat over the medium term. Chinese growth remains key for industrial commodity prices.
Key Domestic Economy Assumptions:			
Food prices	Domestic food price inflation is projected to reach a low of 3.7% in Feb 18, averaging 4.5% for the year as a whole and 5.2% in 2019.	Food price inflation reaches a low point of 3.8% in Q1 18 and averages 4.5% in 2018 and 5.9% in 2019.	Meat price inflation appears to have peaked, but favourable base effects drawing to a close. Persistently dry climatic conditions in the Western Cape remain an upside risk to crop prices, while there have been early reports of farmers curbing maize plantings in key producing provinces due to drought.
Fuel taxes and levies	We assume a 10c/l rise in distribution margins each December and 25 c/l increase fuel excise duties each April. This equates to increases of 4.8% and 4.1% in 2018 and 2019.	Taxes and levies on fuel are expected to rise by 6.3% and 6.7% in 2018 and 2019, respectively.	The 2017/18 Budget mooted the idea of applying VAT to fuel sales (applied to the retail selling price post excise duties). If implemented in April 2018 without any offsetting drop in the fuel levy, it would push up petrol prices by close to 15% m/m, as opposed to the current 1.4% assumption in our model based on 25c/l fuel levy hike.
Electricity prices	We assume a 7% municipal tariff increase in July 2018 and 8% in July 2019. This equates to averages of 4.6% in 2018 and 7.5% in 2019.	Average electricity increases of 5.0% in 2018 and 8.0% in 2019, respectively. These numbers imply that SARB has assumed 8% increases each July.	While NERSA's announcement came as a big surprise, we acknowledge that there could still be some upside risk to our assumption for 2018 if NERSA processes the pending applications for cost-recovering hikes through the Regulatory Clearing Account mechanism.
Growth in government consumption	We forecast real government consumption (G) growth of 0.5% per annum	The SARB no longer publishes its assumption for G.	Public sector wage negotiations, the announcement of fee-free higher education and funding requirements of SOCs could derail efforts of fiscal consolidation and push up G.
Potential growth	1.1%, 1.1% and 1.4% in 2017-2019 respectively	1.1%, 1.2% and 1.3% in 2017 through 2019 respectively.	Assumptions about potential growth are tricky since it cannot be directly observed, but is instead estimated by using statistical techniques on recent GDP trends.
Neutral real interest rate	Absa's model makes no explicit assumption about the neutral real interest rate but we estimate it to be around 1.5%.	From 2017 to 2019 respectively 1.7%, 2.0%, 2.2%.	Globally there is much debate about what the neutral level of real rates is because it cannot be directly observed. However, structural economic shifts in the wake of the global financial crisis have probably lowered the neutral rate everywhere.
Exchange rate	In Absa's macro model, our exchange rate forecast serves as an exogenous input. Our baseline forecast assumes a NEER depreciation of 6.0% and 6.2% in 2018 and 2019 respectively. This equates to REER depreciation of almost 3% in each year.	The SARB's QPM model endogenously determines the exchange rate path, forecasting a NEER depreciation of 5.2% in 2018 and 2.4% in 2019. This equates to an REER depreciation of 1.7% in 2018 but real strengthening of 1.1% in 2019.	The current spot exchange rate is currently significantly more appreciated than our forecast assumes. Hence we decided to run an alternative scenario based on the assumption that the real exchange rate stays constant, because continued good political news might serve to keep the rand strong.
FX pass through to CPI	Our current long-term coefficient is between 10% and 20%, and the short-term pass through is very small at 5%.	20% - SARB also notes that the short-term pass-through coefficient is closer to 10%.	The size of FX pass-through to inflation hard to pin down since it is likely to change over time and be both asymmetric and not linear. It can only be teased out of the data with extremely sophisticated econometric techniques.
Interest rates	Our expectation is that policy interest rates remain constant over the forecast period.	As with the exchange rate the SARB's QPM endogenously determines an interest rate path, which implies three 25bp rate hikes before end 2019.	However, we think the SARB will be very reluctant to cut until it sees residual political and rating event risks pass without renewed rand depreciation.

Source: SARB, Absa Research

FIGURE 53

Alternative forecast scenario: deviation from baseline with a constant REER assumption

		Baseline September 2017 forecast	Baseline January 2018 forecast	Alternative scenario with constant REER	Deviation from baseline under constant REER
GDP growth, %y/y	2018	1.1	1.4	1.3	-0.1
	2019	1.7	1.7	1.6	-0.1
	2020	1.9	1.9	1.8	-0.1
Household consumption, % y/y	2018	1.0	1.3	1.4	0.1
	2019	1.6	1.7	1.9	0.2
	2020	1.9	2.0	2.2	0.2
CPI inflation average, % y/y	2018	5.4	4.8	4.5	-0.3
	2019	5.7	5.5	4.7	-0.8
	2020	5.6	5.5	4.9	-0.6
Current account, % of GDP	2018	-3.0	-2.3	-2.3	0.0
	2019	-3.4	-2.9	-3.1	-0.2
	2020	-3.6	-3.3	-3.7	-0.4

Source: Absa Research

Conclusion: mildly optimistic

Economy is looking somewhat stronger, except on the fiscal front, and should respond positively to political change, but it remains unclear just how quickly or how far political change will materialise

Overall, we are relatively positive on the prospects for the South African economy in 2018 and 2019. We think that many aspects are improving: growth is not spectacular but it is solid enough; inflation looks set to track within the target band; and external balances have improved markedly. Admittedly, fiscal policy and state-owned enterprises remain significant concerns with no easy answers, and in many ways South Africa's new ANC leaders continue to face the same old economy with the same old constraints. Moreover, the ANC remains quite factionalised, with all the challenges this poses for effective policy making.

Nonetheless, we think the political transition that is currently underway will pay material economic dividends, albeit it may take some time for these to fully manifest. South Africa's problems are not likely to be fixed overnight. But should President Zuma be recalled from office soon, we expect a near-term boost to confidence. We recall the first democratic elections in 1994 when the economy was in dire straits and people and businesses were nervous. Nevertheless, the 1994 elections passed peacefully and the palpable sense of relief and liberation provided an immediate lift to the economy. In Q4 93, two quarters before the elections, business confidence stood at 31 and GDP growth excluding agriculture was 1.7% q/q saar. One year later, two quarters after the elections, in Q4 94, business confidence had risen to 67 and GDP growth (excl. agriculture) was 6.0% q/q saar. Some measure of this phenomenon could prevail again.

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