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S&P Global Ratings Raises Its GDP Growth Forecast For South Africa

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South Africa's economy has made a good start to the year. Domestic and foreign investor sentiment has improved markedly following a change in the country's leadership and ensuing policy announcements. Meanwhile, the international backdrop remains supportive, with the ongoing global upturn boosting demand for both commodities and manufactured goods.

We have revised our GDP growth forecast for South Africa up to 2% in 2018, from 1% previously, and 2.1% for 2019, from 1.7%. Improved investor sentiment has translated into a stronger rand, lower inflation, and lower bond yields, compared with our previous expectations. A more favorable inflation outlook has given the central bank room to ease monetary policy. A revival in confidence and lower funding costs should support business investment, while a boost to real income from lower inflation bodes well for household spending. This should more than offset any drag on growth from the announced fiscal tightening.

At A Glance

- New leadership and reform-focused policy announcements have boosted local and foreign investor confidence in South Africa.
- We have revised our growth forecasts to 2% in 2018 and 2.1% in 2019 (from 1% and 1.7% previously).
- Structural challenges related to labor and product market inefficiencies continue to weigh on growth, as do education shortcomings and skills shortages.
- In the medium term, the key question is how quickly reform efforts will ease these structural constraints to economic growth.

Table 1

South Africa Economic Forecast Summary, 2018-2019

(% of change, volume, 2010 prices)	2016	2017	2018f	2019f
Real GDP	0.6	1.3	2.0	2.1
Real GDP per capita	(1.0)	(0.3)	0.4	0.5
Real private consumption	0.7	2.2	2.5	2.6

Table 1

South Africa Economic Forecast Summary, 2018-2019 (cont.)

(% of change, volume, 2010 prices)	2016	2017	2018f	2019f
Real fixed investment	(4.1)	0.4	1.7	2.2
Real exports of goods and services	1.0	(0.1)	3.3	3.3
Real imports of goods and services	(3.8)	1.9	4.0	4.0
Inflation (annual average, %)	6.3	5.3	5.0	5.2
Unemployment rate (%)	26.7	27.5	27.4	27.3

f--S&P Global Ratings forecast. Sources: S&P Global Ratings, SARB, Statistics South Africa.

Our revised growth forecast for 2018 also takes into account recent statistical releases. The economy finished 2017 on a high note, with annualized quarterly growth jumping to 3.1% in the fourth quarter. Moreover, historical revisions to national accounts show somewhat more resilience compared with data reported previously. Taken together, this implies a stronger carry-over this year and lifts 2018 growth.

The ongoing rebound in the agricultural sector since the end of the drought was the major driver of fourth-quarter GDP growth, contributing 0.8 percentage points. Activity picked up across most sectors, except mining where output dropped after three quarters of strong growth, and construction, which remained weak. Mining output rebounded in January, growing by 1.1% on the previous month in seasonally adjusted terms, or 2.4% on an annual basis.

New Leadership And Policies Are Boosting Investor Confidence

Investor sentiment has visibly improved since Cyril Ramaphosa was elected as leader of the African National Congress (ANC) in December and became head of state in February. Policy announcements, including a sizable fiscal adjustment and measures to improve the governance of state-owned enterprises (SOEs), have helped assure domestic and foreign investors.

In February, foreign investors placed US$3.2 billion (about 1% of GDP) into South African debt and equity, based on preliminary data from the Institute of International Finance (IIF). Remarkably, this happened amid market jitters, with most emerging markets experiencing outflows of foreign portfolio capital in February. IIF data suggests non-resident portfolio inflows into South African assets continued in March, outperforming most emerging market peers. The rand has rallied, appreciating by about 20% against the dollar since its low point in November, while bond yields have eased by more than 100 basis points since the end of November (chart 1).

Chart 1

South African Rand vs U.S. Dollar And 10-Year Government Bond Yields

Source: DataStream

Domestically, business confidence is on the rise. The FNB/BER Business Confidence Index surged by 11 points in the first quarter of 2018, bringing it to its highest level since the beginning of 2015. The ABSA PMI index crossed the neutral 50 threshold, climbing to 50.8% in February.

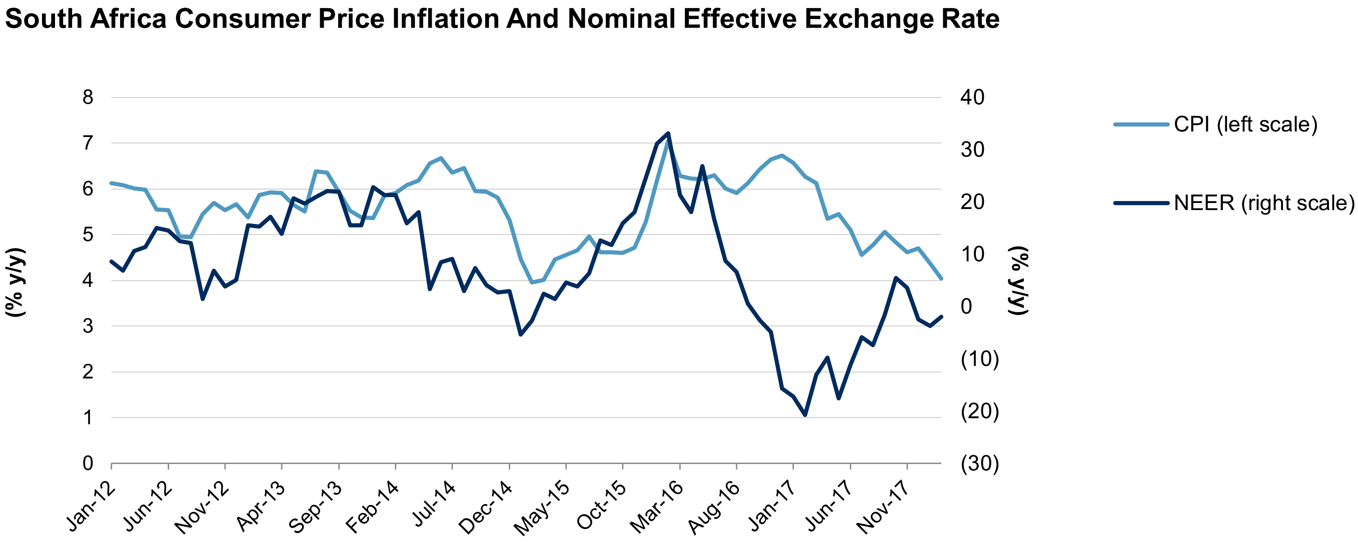
As Fiscal Policy Tightens, Monetary Easing Should Support Growth

The government presented its 2018 budget in February. It contains several measures to reduce the budget deficit and stabilize public debt, notably a VAT hike in April (the first time in 25 years) by 1 percentage point to 15%, as well as limiting personal income tax bracket adjustments. While the announced fiscal adjustment has helped boost confidence, these measures are likely to weigh on demand in the short term.

The improved inflation outlook suggests there's room for monetary policy easing. Consumer price inflation declined to 4% in February (chart 2), at the lower end of the South African Reserve Bank's (SARB's) target range of 3%-6%, from 6.3% a year ago. Core inflation (CPI excluding food and non-alcoholic beverages, fuel and energy) also eased to 4.1% in January-February. While previous depreciation pushed inflation up, the trend has reversed and the appreciating exchange rate is now supporting disinflation. The trade-weighted exchange rate was on average 9% stronger in 2017 compared to 2016, and has appreciated further this year. A slowdown in food price inflation thanks to lower agricultural prices has been another factor.

The impending VAT increase will likely push inflation toward the higher end of the target range, but the SARB should, in principle, see through this temporary surge in inflation. Still, given possible second-round effects from the VAT hike, as well as rising global interest rates, the SARB may be reluctant to ease policy more forcefully. We expect one policy rate cut this year, which would bring it to 6.5%.

Chart 2



Sources: South African Reserve Bank, S&P Global Ratings calculations.

Short-Term Risks Are Mainly External, With Domestic Policies Key To Medium-Term Growth

On the external side, downside risks to South Africa's economic outlook relate to foreign trade and financing. Our base case is for an ongoing global upturn and robust growth in world trade, which should support South Africa's exports, both commodities and manufactured goods. The downside risk is linked to the U.S. administration's recent decision to introduce tariffs on steel (25%) and aluminum (10%). For South Africa, the direct economic impact of tariffs should be minimal. Steel exports to the U.S. accounts for just 0.1% of GDP, and total base metal exports to the U.S. (predominantly iron ore) is 0.3% of GDP. However, escalating global trade tensions could dampen exports, confidence, and growth globally, including in South Africa.

The risk of steeper interest rate raises for the U.S. and other advanced economies has also increased after the U.S. congress adopted a $1.5 trillion tax package in December 2017. The large fiscal stimulus comes at a time when the U.S. economy is in a mature phase of recovery, and is operating at near-full employment. This increases the risk of higher inflation and interest rates in the U.S., with a spill-over to other advanced economies. This may lead to a sharp slowdown or an outright reversal of foreign financial flows to emerging markets.

The South African economy remains exposed to tightening global liquidity conditions, due to persistent current account deficits financed by volatile foreign flows. Its external position improved last year, with the current account deficit narrowing to 2.5% of GDP, although this largely reflects subdued economic growth and weak imports. We expect the external gap to widen to about 3% of GDP as growth and imports pick up. In contrast to 2014, we no longer see South Africa as one of the "Fragile Five" emerging economies that are most vulnerable to the normalization of monetary conditions in advanced economies (see "Sovereign Postcard: The New Fragile Five," published on Nov. 6, 2017). Rather, it's now in the middle of the range.

South Africa's growth remains constrained by structural challenges related to labor and product market inefficiencies, including in the large SOE sector, and poor education outcomes and skills shortages. GDP growth of just above 2.0%, or 0.5% in per capita terms, is very low for a country with South Africa's income levels, and not sufficient to meaningfully reduce its very high unemployment levels.

In the medium term, the key question is how quickly reform efforts will ease these structural constraints to economic growth. The government has taken some steps to improve governance of SOEs, which is an important development. We are yet to see reform progress in other areas, particularly concerning the rigid labor market with its inefficient wage-setting mechanisms and high barriers to entry and exit.

The government is still engaging with the mining sector to reduce policy uncertainty in the regulatory environment and conclude the long-outstanding legislative frameworks. On the other hand, land reform debate has come to the fore following the ANC resolution at its December 2017 elective conference and subsequent adoption of the motion in parliament to consider land expropriation without compensation. A Constitutional Review Committee has therefore been set up to consider the matter and involve a public consultation process that could inform the way forward. We, therefore, do not expect a resolution on the matter in the near term.