Rabobank

Country report

SOUTH AFRICA

Summary

South Africa's economy recovered, after a year-long recession in 2009. In 2010, the economy grew by 2.8%. Growth was largely demand driven, with an increase in both external and domestic demand fuelling growth in, among others, the manufacturing sector. In addition, the FIFA World Cup helped raise tourism receipts. However, increased public spending during the recession caused a budget deficit of over 5%, while reduced exports caused a current account deficit of 3.9%.
For 2011, we expect the recovery to continue with growth reaching 3.7%. Although these expectations are promising, much higher growth rates are needed to create employment opportunities for the 25% of the population that are currently unemployed. Especially high youth unemployment is worrisome. Battling the high unemployment rate is vital, as unemployed youths are more susceptible to a life of crime. Moreover, growing discontent with the government's inability to find a solution, will likely fuel social unrest.

Things to watch:

- High unemployment rate of nearly 25%
- High crime rate
- Public spending (in light of the country's twin deficits)

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South Africa

National facts		
Type of government	Federal republic	
Capital	Capetown and Pretoria	
Surface area (thousand sq km)	1,219	
Population (millions)	49.1	
Main languages	English, Afrikaans	
	9 local languages	
Main religions	Christian (68%)	
	Traditional African (29%)	
	Other (3%)	
Head of State (president)	Jacob Zuma	
Head of Government	Jacob Zuma	
Monetary unit	Rand (ZAR)	
Economy		**2010**
Economic size	*bn USD*	*% world total*
Nominal GDP	364	0.58
Nominal GDP at PPP	522	0.71
Export value of goods and services	100	0.54
IMF quota (in m SDR)	1869	0.86
Economic structure	*2010*	*5-year av.*
Real GDP growth	2.8	3.7
Agriculture (% of GDP)	3	3
Industry (% of GDP)	31	31
Services (% of GDP)	67	66
Standards of living	*USD*	*% world av.*
Nominal GDP per head	7412	75
Nominal GDP per head at PPP	10633	91
Real GDP per head	5873	73

Social and governance indicators	rank / total
Human Development Index (rank)	129 / 182
Ease of doing business (rank)	34 / 183
Economic freedom index (rank)	72 / 179
Corruption perceptions index (rank)	55 / 180
Press freedom index (rank)	33 / 175
Gini index (income distribution)	57.8
Population below $1 per day (PPP)	26%

Foreign trade			2009
Main export partners (%)		*Main import partners (%)*	
US	11	Germany	20
Japan	10	China	13
UK	10	US	8
China	9	Angola	6

Main export products (%)	*2010*
Platinum	13
Gold	12
Coal	7
Cars & other components	3
Main import products (%)	
Petrochemicals	17
Equipment components for cars	6
Motor cars & other components	4
Petroleum oils & other	5
Openness of the economy	
Export value of G&S (% of GDP)	27
Import value of G&S (% of GDP)	28
Inward FDI (% of GDP)	1.4

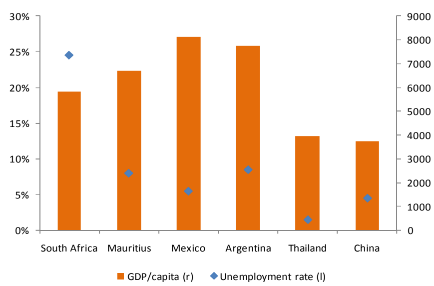
Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economic structure and growth

In many ways, South Africa is the odd one out. Its open economy is larger than that of any other country in Sub-Saharan Africa and is among the most developed in the region. In addition, the level of economic diversification seen in South Africa is unlike that of other African countries.
For this reason it would be incredibly hard to identify South Africa as a typically African country (if ever such a country existed). Yet, with an average growth rate of only 3.7% in the past five years, it also does not fit in with the fast growing emerging economies.
As said, the South African economy is relatively diversified. In contrast to many African countries, agricultural production only accounts for 3% of GDP, while manufacturing accounts for a respectable 15% of GDP. In addition, the mining sector accounts for 10% of GDP. Finally, South Africa has a large services sector, which makes up 67% of GDP. Especially financial services and communication services are important drivers of growth.
In 2009, South Africa experienced its first recession since 1992. The recession underscored South Africa's vulnerability to the shocks in external demand. Moreover, the drop in external demand went hand in hand with reduced domestic demand. As a result of tighter credit conditions at home, combined with high private indebtedness and a reduction in employment, consumer spending dropped by 2% in real terms (2009). Consequently, the economy shrunk by 1.8%. Especially the manufacturing sector was hit hard, but also mining output declined.
Although the recession was short-lived, recovery remains sluggish. Throughout 2010, growth rates improved somewhat, reaching 3.8% yoy in the last quarter. The annual growth rate stood at 2.7%. Economic recovery was mostly demand driven, with low inflation, reduced interest rates and higher wages all driving up demand. Moreover, the World Cup helped raise both domestic spending and

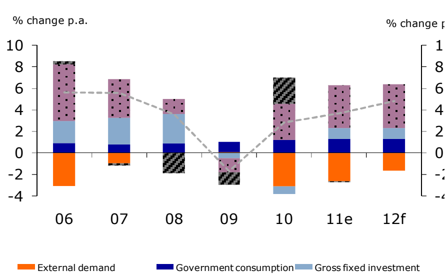
tourism receipts. Increased domestic demand also helped generate growth in the manufacturing sector, which had been in recession since 2006 and grew by 4.1% in 2010.
For 2011, we expect this recovery to continue, with GDP growth reaching 3.8%. As in 2010, we expect growth to be demand driven. Especially the high wage settlements reached in 2010, an improved economic outlook and more relaxed credit conditions, should help keep consumer demand on the rise. In addition, the government is expected to maintain a high level of public spending so as to further stimulate the economy.
In the medium to long run, growth is constrained by a number of bottlenecks that continue to reduce the country's productivity as well as its attractiveness to foreign investors. One of the most persistent problems is the country's high crime rate. Especially the number of violent crimes is high and likely to frighten potential investors. An often-cited reason for the current level of criminal activity is the country's high unemployment rate of nearly 25%. Especially high youth unemployment is thought to fuel criminality. Unemployment in turn, is in part caused by a mismatch between labor demand and supply: While South Africa has an overabundance of unskilled labor, skilled labor is in strong demand, but in short supply. This underscores the pressing need for improved education and access to schooling.
Furthermore, high prevalence of HIV/AIDS in South Africa continues to undermine productivity. Although the government has undertaken various measures to improve the current health situation, the problem of AIDS remains a difficult one to tackle. Another factor in need of improvement is the country's high corruption rate. Despite various efforts to halt corrupt practices, widespread corruption continues to affect South Africa's reputation abroad. Finally, power shortages drive up operational costs.
Fortunately, there are also some positive developments that will improve South Africa's business environment. For one, a new power plant coming online in 2013 should resolve much of the current power shortages. Furthermore, in preparation for the FIFA World Cup, South Africa invested heavily in infrastructure. The many new, or improved roads and better public transport will help reduce operational costs.

Chart 1: Income level



Source: EIU

Chart 2: Composition of growth



Source: EIU

Despite the many bottlenecks on the supply-side, developments on the demand-side seem more promising. During the past few years, South Africa's middle class has expanded considerably. Higher wages and better opportunities for the large black majority helped create a larger and more diverse middle class. Although this development is still young and further improvements are vital, it is at least promising. A larger middle class could attract foreign investors and create more opportunities for South African businesses. However, we should not forget that South Africa is still a very divided country and income inequality remains a pressing problem. Moreover, the recession partly reversed this trend.

As mentioned, the global turmoil and reduced global production also reduced external demand for South African coal and car exports. With a sluggish recovery in the EU, South Africa's main export market, we expect exports to remain below their pre-crisis levels. In this light, the country's recent shift towards the east (and specifically China) is a positive development.
South Africa's large banking sector was hit by the crisis as well. However, the effects were short-lived. South African banks hold relatively few foreign assets and only 7% of all bank liabilities were denominated in foreign currencies. Nonetheless, banks did feel the impact of the domestic recession. High household indebtedness (83% of available income) presented an immediate risk, as the recession pushed many into bankruptcy. As a result, the percentage of bad loans rose to 6%. However, prudent supervision and regulation of the banking sector ensured that the sector remained healthy throughout.

Political and social situation

In 2009, African National Congress (ANC) leader Zuma became South Africa's third president since apartheid was abolished in 1994. However, the charismatic president has since lost the support of many within the ANC, its alliance partners, and the country. On the one hand, the large black majority living in South Africa is growing increasingly weary of the many promises made by Zuma and his predecessors and the little results they have so far delivered. The fifteen years since apartheid did not completely abolish the ethnical divides, with a large percentage of the black population still living in poverty. Unsurprisingly, many are wondering when they will see the changes promised in 1994. In a country where almost 25% of the population is unemployed, 26% of the population still lives below the poverty line and crime is obstructing almost every aspect of day-to-day life, their claims are understandable. On the other hand, the private sector is concerned that state interventions in favor of the unemployed poor will pollute the business climate and thereby decrease the competitiveness of businesses. So, while Zuma's failure to create jobs has lost him the support of the left-wing of the ANC, most attempts to right this wrong will reduce support among right-wing ANC fractions.
In September 2010, in an attempt to overcome these opposing criticisms and ensure the support of his coalition partners, Zuma reshuffled the government. Seven ministers were dismissed. Zuma claims that the reshuffle will go a long way in improving the implementation of various pro-poor programs. In addition, Zuma secured at least one more year in office by convincing the ANC not to take any decisions against him before the party's National Elective Conference in 2012.
In the past, infighting in the ANC had little impact on the popularity of the party itself. A large number of small opposition parties meant that the ANC was ensured a majority share in any election. However, opposition parties are gaining momentum. A merger between Democratic Alliance (DA) and Independent Democrats (ID) has created a more meaningful opposition. Moreover, it is expected that they will soon join forces with other opposition parties as well. This could create an opposition party strong enough to stand a chance against the ANC in the 2014 presidential elections. Of course, it is far too early to formulate any meaningful expectations.
Despite turbulence at home, South Africa will remain an important regional and international player. The country holds strong relations with the EU and US, has a temporary seat on the UN Security Council and a permanent seat in the G20. Moreover, as the largest economy on the continent, South Africa plays and will continue to play an important role in Africa as well; both as a mediator and a promoter of economic development.

Economic policy

The policy agenda is dictated by the country's persistent unemployment rate. Consequently, policy is geared towards employment growth. The government is set to implement various programs that would create employment opportunities, while simultaneously creating human capital. These programs include new schooling opportunities, subsidized employment and employment programs specifically targeting the large youth population. Unfortunately, the strategy does not include broad-based and far stretching labor market reforms. Labor unions enjoy significant power and are generally able to negotiate high wages. This only makes it harder for outsiders (the unemployed) to gain employment. However, it is feared that instead of liberalizing the labor market, the government will only tighten its grip on the private sector.

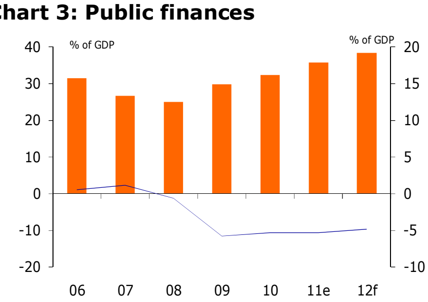
Zuma further fuelled fears of increased intervention when he threatened to nationalize the country's mines. He stated that nationalization of the country's mines is the only way to create a more equal society. The mines are currently in the hands of large international corporations and profits of natural resources hardly trickle down to other segments of the population. However, it is doubtful that nationalizing the mines will create a more equal society. This would depend on the government's ability to better allocate resources to pro-development programs. Evidence suggests otherwise. Moreover, in light of the fierce opposition, it is also doubtful whether these nationalization plans will ever be realized.

Although creating employment remains an obstacle, South Africa generally performs well on most other macroeconomic indicators. Prudent macroeconomic policy allowed the government to increase its spending in light of the recession. Anti-cyclical spending did increase the budget deficit, but not to unsustainable levels. In 2009 the budget deficit reached 5.8% of GDP. 2010 saw a slight improvement and the budget deficit stood at 5.3% of GDP. The higher deficit in the past two years also reflects a fall in tax revenue. Nonetheless, the number of taxpayers increased, suggesting improvement in the quality of tax collection.

Although a somewhat inflated budget deficit is considered reasonable in times of economic contraction, it should disappear once the economy recovers. For this reason an expected deficit of 5.3% of GDP in 2011 thus gives reason for concern. Especially in light of the large and expanding current account deficit. The government is thus advised to return to the prudent macroeconomic policies we saw before the crisis. The outstanding reputation of the country's Minister of Finance, Manual Trevor, provides some comfort. However, the upcoming elections and the pressure on Zuma to increase spending on social programs may stand in the way of fiscal tightening.

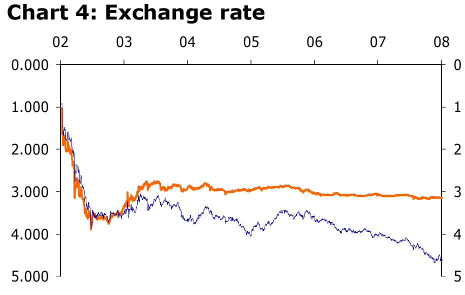
Public debt stood at a sustainable 32% of GDP in 2010. For 2011, we expect a slight increase in public debt levels to 36% of GDP, as the government is set to increase spending and investments. Monetary policy focuses on maintaining inflation within the 3%-6% band employed by the Central Bank. In 2010, we saw inflation decrease from 7.2% in 2009 to 4.1% in 2010. However, for 2011, we expect that increased domestic demand, high wages, a weak rand and increasing food and fuel prices will push inflation towards 4.6%.

Chart 3: Public finances



Source: EIU

Chart 4: Exchange rate



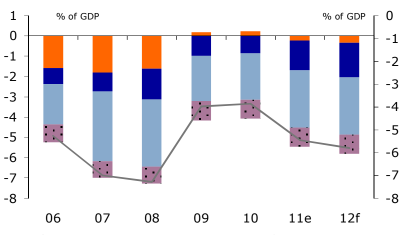
Source: EcoWin

The value of the rand against both the dollar and the euro fluctuated considerably in the past few years. Although the rand is allowed to float freely, the central bank did attempt to smooth the exchange rate through open market operations. However, the effects were minimal. In 2011, we expect higher inflation and an increase in the current account deficit will keep pressure on the rand.

Balance of Payments

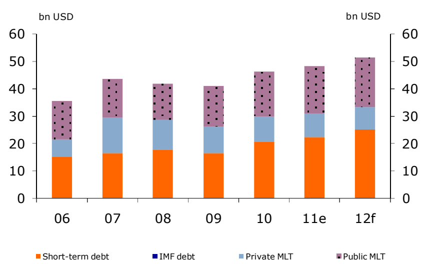
South Africa generally runs a current account deficit. For 2011, we expect the deficit to widen, as all components of the current account are expected to report a widening deficit.
The trade balance reported a small surplus of 0.2% of GDP in 2010. However, as domestic demand is recovering faster than demand in South Africa's main export markets, we expect a deficit of 0.2% in 2011. Especially the fragile recovery in the EU, South Africa's main export market, and the recent earthquake and tsunami in Japan, will keep exports low. At the same time imports are expected to increase, as larger investments will lead to a rise in imports of capital goods. Moreover, higher fuel prices will drive up the costs of petroleum imports.
The invisible balance (services, income and transfers) reports a far larger deficit, which is expected to increase. A widening services deficit reflects the fall in tourism receipts after the FIFA World Cup. An increasing deficit on the income balance is the result of increased GDP growth and thus an increase in profit repatriation by foreign investors. Finally, a minor increase of the transfer deficit will be the result of aid payments to neighboring countries and an increase in outward remittances. Despite these unfavorable trends, the current account deficit will remain sustainable at 5.5% of GDP in 2011 (from 3.9% of GDP in 2010). Moreover, inward net foreign direct investment flows are slowly recovering and expected to reach 1.7% of GDP in 2011 (from 1.4% of GDP in 2010). However, the recent build-up in official reserves mostly reflects an increase in portfolio flows. This implies that a sudden change in market sentiment and a subsequent withdraw of investments could rapidly lower official reserve levels.

Chart 5: Current account



Source: EIU

Chart 6: External debt



Source: EIU

External position

Total external debt increased slightly from USD 41bn in 2009 to USD 46bn in 2010. Nonetheless, as a percentage of GDP external debt decreased from 14% of GDP to 13% of GDP. Around 44% of external debt is short term debt. On the one hand, larger shares of short term debt are relatively normal for more developed and open economies. On the other hand, a large percentage of short term debt does create risks. However, a debt service ratio of 26% of total exports is deemed sustainable. Moreover, official reserves cover 169% of total debt service due (2010).

South Africa

Selection of economic indicators	2006	2007	2008	2009	2010	2011e	2012f
Key country risk indicators							
GDP (% real change pa)	5.6	5.6	3.6	-1.7	2.8	3.7	4.8
Consumer prices (average % change pa)	3.2	6.2	10.1	7.2	4.1	4.6	5.3
Current account balance (% of GDP)	-5.3	-7.0	-7.3	-4.0	-3.9	-5.5	-5.8
Total foreign exchange reserves (mln USD)	23057	29589	30584	35237	38175	41770	42540
Economic growth							
GDP (% real change pa)	5.6	5.6	3.6	-1.7	2.8	3.7	4.8
Gross fixed investment (% real change pa)	12.1	14.0	14.1	-2.2	-3.1	5.1	4.8
Private consumption (% real change pa)	8.3	5.5	2.2	-2.0	5.4	6.2	6.2
Government consumption (% real change pa)	4.9	4.1	4.7	4.8	6.0	6.3	6.0
Exports of G&S (% real change pa)	7.5	6.6	1.8	-19.5	5.0	6.0	7.3
Imports of G&S (% real change pa)	18.3	9.0	1.5	-17.4	15.8	13.2	10.3
Economic policy							
Budget balance (% of GDP)	0.5	1.2	-0.6	-5.8	-5.3	-5.3	-4.8
Public debt (% of GDP)	31	27	25	30	32	36	38
Money market interest rate (%)	7.2	9.2	11.3	8.2	6.2	5.5	5.8
M2 growth (% change pa)	21	20	15	7	12	7	8
Consumer prices (average % change pa)	3.2	6.2	10.1	7.2	4.1	4.6	5.3
Exchange rate LCU to USD (average)	6.8	7.0	8.3	8.4	7.3	7.6	8.4
Recorded unemployment (%)	23.9	23.3	22.9	24.0	24.9	23.9	23.3
Balance of payments (mln USD)							
Current account balance	-13745	-20019	-20083	-11327	-14091	-20260	-21040
Trade balance	-4195	-5161	-4448	533	804	-860	-1220
Export value of goods and services	65824	76436	86119	66542	85253	80290	81360
Import value of goods and services	70020	81596	90567	66008	84449	81150	82580
Services balance	-2028	-2663	-4170	-2787	-3141	-5430	-6200
Income balance	-5161	-9843	-9133	-6389	-8321	-10480	-10200
Transfer balance	-2362	-2351	-2333	-2684	-3434	-3500	-3420
Net direct investment flows	-6112	2755	11764	4043	2298	3050	5250
Net portfolio investment flows	18053	5596	-13605	11865	16239	16600	17120
Net debt flows	6597	6672	-147	-624	5472	2290	3510
Other capital flows (negative is flight)	165	12352	23197	1649	-5764	580	-4080
Change in international reserves	4957	7356	1126	5606	4154	2240	760
External position (mln USD)							
Total foreign debt	35523	43610	41943	41025	46220	48230	51440
Short-term debt	15260	16558	17937	16485	20666	22410	25230
Total debt service due, incl. short-term debt	15180	20524	21112	24046	22626	27140	29270
Total foreign exchange reserves	23057	29589	30584	35237	38175	41770	42540
International investment position	-41069	-68380	-11294	-10662	n.a.	n.a.	n.a.
Total assets	182500	214832	181299	181116	n.a.	n.a.	n.a.
Total liabilities	223569	283212	192593	191778	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-1.6	-1.8	-1.6	0.2	0.2	-0.2	-0.3
Current account balance (% of GDP)	-5.3	-7.0	-7.3	-4.0	-3.9	-5.5	-5.8
Inward FDI (% of GDP)	-0.1	2.0	3.5	1.9	1.4	1.7	2.2
Foreign debt (% of GDP)	14	15	15	14	13	13	14
Foreign debt (% of XGSIT)	42	44	39	49	43	46	48
International investment position (% of GDP)	-15.7	-23.9	-4.1	n.a.	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	18	21	20	29	21	26	27
Interest service ratio incl. arrears (% of XGSIT)	1.9	1.9	1.7	1.6	1.4	1.6	1.6
FX-reserves import cover (months)	3.3	3.6	3.4	5.2	4.5	4.9	4.9
FX-reserves debt service cover (%)	152	144	145	147	169	154	145
Liquidity ratio	126	130	133	145	142	136	134

Source: EIU