South Africa Q1 20 Quarterly Perspectives

Struggling for growth as SARB cuts 25bp

We have cut our GDP forecasts sharply. Persistently weak business sentiment and ongoing bouts of load shedding are constraining South Africa's growth prospects, while the drought seems likely to have a significant negative effect this year as well. We now forecast real GDP growth of just 0.3% for 2019, 0.9% this year and 1.2% in 2021.

Inflation has probably bottomed out but is likely to remain well contained within the 3-6% target. Despite likely upside pressures from administered prices (and maybe food, as drought takes hold), demand weakness continues to nullify pricing power for market-determined prices. We believe CPI inflation is likely to print at an average of 4.1% in 2019, rising to 4.4% in 2020.

Fiscal policy is a huge problem for South Africa, with stuttering tax collections, and an apparent unwillingness of the government to cut the public sector payroll. The 2020 Budget to be presented on 26 February is key. We think the government will once again rely primarily on taxes to try to narrow the deficit, and in particular, we are making the bold call of a 1pp rise in the VAT rate.

Calling the SARB's decisions with a divided MPC is challenging given low inflation and growth, but big looming risks. On 16 January, the MPC cut the repo rate by 25bp. We expect rates to remain on hold for the foreseeable future, but see the risks skewed somewhat in favour of more easing rather than hikes, particularly as we believe inflation could continue to be lower than the SARB's expectations.

The ZAR is likely to weaken back up to around 15 per USD. Both our valuation models suggest that the ZAR is overvalued, which together with the prospect of significant capital outflows during the first half of the year, explains our bearish view on the ZAR during Q1.

Eskom continues to be a major source of fiscal and general macroeconomic risk. The unbundling programme laid out in the discussion paper last year on its own cannot fix the electricity sector's challenges and the pushback against reforms at Eskom is intense. Load shedding is likely to continue and Eskom may need even more bailout money than that already allocated by the government.

Structural reforms accelerated a little towards the end of last year, although progress overall has been slow, in part due to political contestation. In 2020, the energy sector reform is by far the most important structural reform to get right, but the auction of broadband spectrum is also key.

South Africa's political functionality continues to be hobbled by the factional battle within the ANC. It remains to be seen if President Ramaphosa's efforts to restore constitutional governance and roll back 'state capture' will pay dividends sufficiently quickly. The National General Council at mid-year is a big risk for President Ramaphosa's reform drive.

Further credit rating downgrades seem likely. In particular, we think Moody's is more likely than not to act on its Negative Outlook and downgrade South Africa to sub-IG on 27 March.

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Growth outlook is constrained by load shedding and persistently weak demand

GDP growth fell by 0.6% q/q saar in Q3 19 but some encouraging signs emerged from the underlying demand-side data

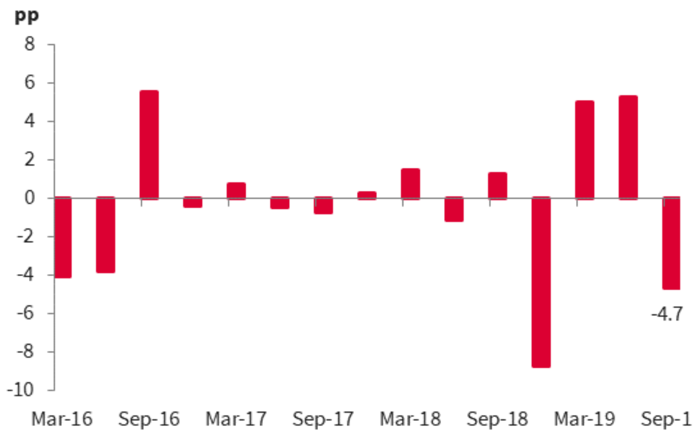
Economic activity was characterised by a high degree of volatility in 2019. After rebounding from a 3.1% q/q saar contraction in Q1 with a 3.2% gain in Q2, real GDP declined again by 0.6% in Q3.From the production side, the Q3 fall was broad-based (Figure 1). However, despite the disappointing headline GDP print in Q3, some encouraging signs emerged in the demand-side data. Household consumption expenditure showed further resilience, rising by 0.2% q/q saar in Q3 compared to 2.6% in Q2. Significantly, gross fixed capital formation rose by 4.5% q/q saar in Q3 after strong growth of 5.8% in Q2. Net exports also contributed positively to GDP growth in Q3 following some improvement in export growth. However, from a demand perspective, a large inventory drawdown in the quarter offset contributions by other components, resulting in expenditure-side GDP (excluding the residual) falling by 0.3% q/q saar in Q3 19 (Figure 2).

Figure 1: Broad-based contraction in GDP in Q3 19

% q/q saar	Q3 18	Q4 18	Q1 19	Q2 19	Q3 19
Agriculture	13.7	7.9	-16.8	-4.2	-3.6
Mining	-8.9	-3.8	-10.8	17.4	-6.1
Primary sector	-4.0	-1.1	-12.3	11.9	-5.5
Manufacturing	7.5	4.5	-8.8	2.1	-3.9
Utilities	0.8	0.2	-7.4	3.2	-4.9
Construction	-1.7	-0.7	-2.0	-1.4	-2.7
Secondary sector	4.9	3.0	-7.4	1.5	-3.8
Trade & accom.	3.4	-0.7	-3.6	3.4	2.6
Transport / comms.	6.8	7.7	-4.4	-0.3	-5.4
Finance, real estate	2.1	2.7	1.1	4.1	1.6
Personal svcs.	0.6	1.7	1.1	0.8	0.4
Gov't services	1.9	-0.6	2.4	3.2	2.4
Tertiary sector	2.9	1.7	-0.4	2.9	0.9
GDP	2.6	1.4	-3.1	3.2	-0.6

Source: Stats SA, Absa Research

Figure 2: Large inventory drawdown weighed on demand side GDP in Q3

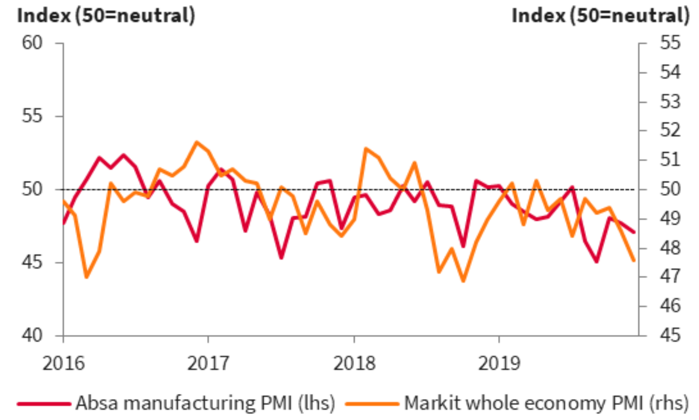


Source: Stats SA, Absa Research

We expect a slight rebound of 0.4% q/q saar in Q4 19 GDP

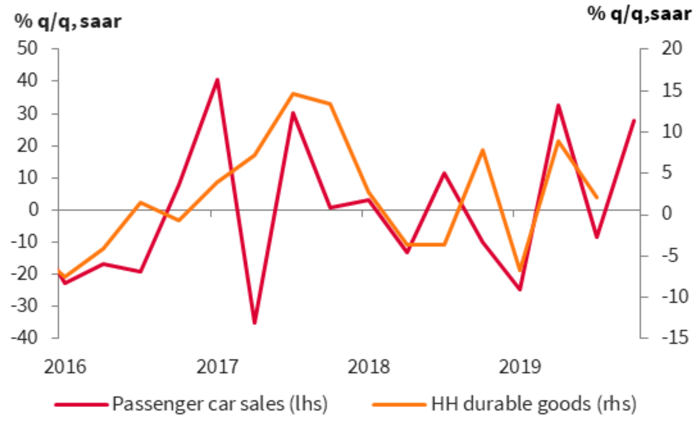
The Q4 19 GDP data, which will only be published on 3 March, also seem set to be weak, partly due to renewed power cuts. But we believe a modest recovery from the Q3 contraction is likely. The available activity data for Q4 19 are mixed but generally quite subdued. After a promising start to the quarter, with growth of 2.5% m/m (sa) in October, manufacturing output fell by 1.5% m/m (sa) in November. Meanwhile, mining output fell sharply by 3.5% m/m (sa) after growth of 1.7% m/m sa in October. The severe electricity constraints in December are likely to cause further weakness on the production side of the economy. Electricity output had already fallen by 0.5% m/m (sa) in October and by 1.4% m/m (sa) in November. Additionally, both the Absa and Markit PMIs fell even deeper into contractionary territory in December (Figure 3). However, the demand side of the economy will provide an offset to the production side weakness, thanks in part to the 'Black Friday' effect, which we believe is not fully accounted for in Stats SA's seasonal adjustment framework. Encouragingly, passenger vehicle sales rose by a seasonally adjusted and annualised 27.7% q/q saar in Q4 2019 (Figure 4). Meanwhile, constant price retail sales rose by a solid 3.1% m/m (sa) in November after remaining about flat in October. Overall, we expect Q4 19 GDP data to reflect a small rebound of 0.4% q/q saar, helping South Africa to avoid slipping into its second recession in as many years.

Figure 3: Load shedding in Q4 2019 weighed on both PMIs



Source: BER, IHS Markit, Absa Research

Figure 4: Passenger vehicle sales rose sharply in Q4 2019

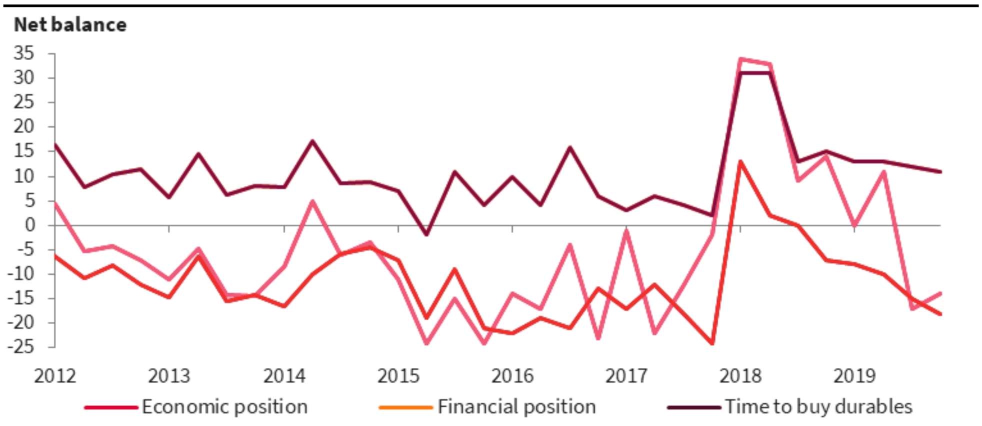


Source: Stats SA, NAAMSA, Absa Research

The weak labour market is likely to continue to constrain the contribution to growth from the consumer

Beyond Q4 19, some of the long-standing features of South Africa's general growth weakness seem likely to persist. Key among these is the constrained state of the consumer, since household expenditure accounts for about 60% of GDP. Consumer sentiment has weakened recently and is likely to remain low amid ongoing headwinds. The Q4 19 BER Consumer Confidence Index (CCI) remained at a weak level of -7 index points. An interesting and fairly consistent characteristic of the CCI data is that households remain relatively upbeat about their own finances. However, the two main factors that weigh on sentiment are households' assessment of the outlook of the economy and their rating of the present as a time to buy durable goods (Figure 5). But of course, the weak sentiment is also because of fundamental challenges, the most significant being the labour market. There is some volatility in the official labour market data, which makes labour market analysis difficult. Nonetheless, the Quarterly Labour Force Survey (QLFS) shows that despite some gains in Q2 and Q3 19, net total employment is still lower than at the end of 2018 by 154k. Meanwhile, the Quarterly Employment Statistics (QES), an enterprise-based survey that covers only the formal non-agricultural sector, showed that formal employment fell by 28k q/q in Q3 compared to a decline of 4k q/q in Q2 and after 22k job gains in Q1. Forward-looking surveys of private sector hiring intentions suggest that job prospects remain grim. Meanwhile, government employment will also be under pressure amid the growing need for fiscal consolidation.

Figure 5: Households have a dire outlook about the economy



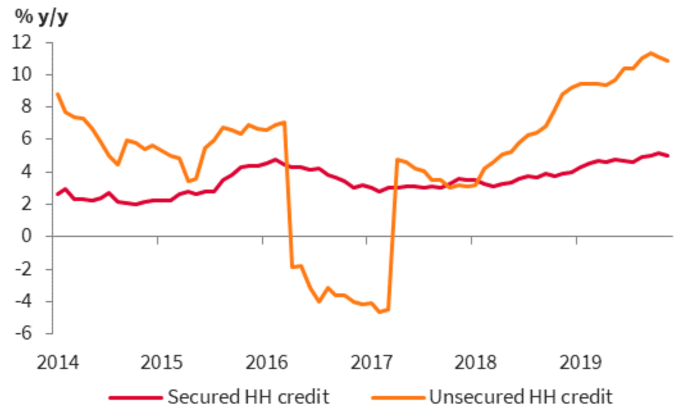
Source: BER, Absa Research

Subdued income growth partially supplemented by the credit cycle

Income growth also remains subdued as a result of the weak labour market. According to the SARB Quarterly Bulletin, nominal disposable income growth slowed from 4.8% y/y in Q2 to 4.4% y/y in Q3, the lowest since Q3 2009. But, real disposable income growth rose by 0.3pp to 1.3% y/y in Q3, thanks to lower inflation. However, while income growth remains lacklustre, the credit cycle appears to be providing some support to the consumer. Household credit extension has picked up gradually, reaching 6.6% y/y in November, with most of this coming from unsecured credit

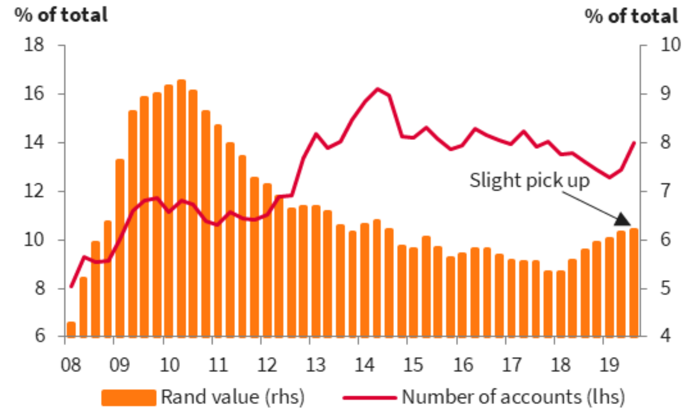
(Figure 6). We are sceptical about the sustainability of this trend in credit growth in the absence of sustained job and income growth. But positively, both the Q3 National Credit Regulator and TransUnion data on arrears thus far suggest that although the consumers remain under pressure, they are not in crisis (Figure 7). However, further pressure is likely to come from additional tax increases this year (we forecast a 1pp increase in the VAT rate), a resort to intentional bracket creep, and fast-rising administered inflation.

Figure 6: Credit growth extended to households moderates



Source: SARB, Absa Research

Figure 7: Arrears rose mainly in small-value loans

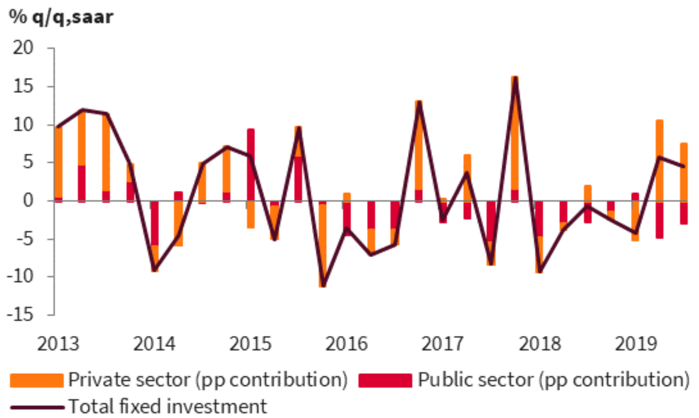


Source: NCR, Absa Research

Depressed business sentiment likely to weigh on private investment

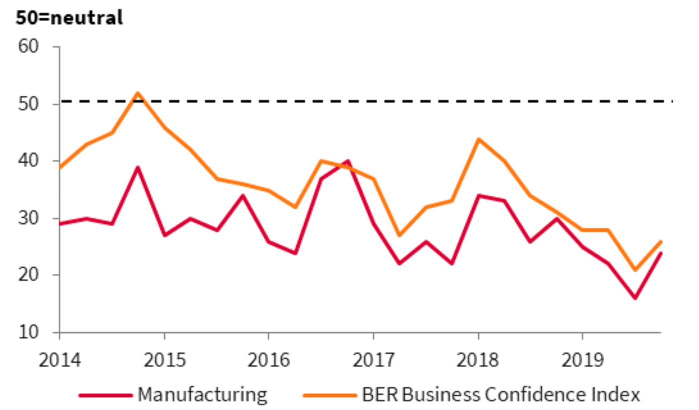
Turning to investment, we believe that faltering public investment and weak business sentiment overall are likely to weigh on total investment spending over the foreseeable future. The rise in gross fixed capital formation in Q3 was due to private investment growth of 10.8% q/q saar in Q3 from a solid gain of 15.8% in Q2 (Figure 8), which at first appeared odd given the poor readings of BER Business Confidence Index (BCI). However, we believe that the rise in private fixed investment spending in Q2 and Q3 mostly reflected investments in renewable projects that were signed in April 2018 but where construction started mostly in 2019. Construction works on renewable energy projects is likely to continue into 2020 and support the overall private investment, but quite narrowly. On a broader scale, low business sentiment is likely to dampen private investment. Despite improving slightly from 21 index points in Q3 to 26 points in Q4, the BCI is still deep into pessimistic territory (Figure 9).

Figure 8: Private investment surges in Q2 and Q3 2019



Source: Stats SA, Absa Research

Figure 9: Despite recovering, confidence is still low



Source: BER, Absa Research

Dry weather conditions add to downside risks to 2020 growth

Looking ahead into 2020, weather conditions are likely to negatively affect agricultural production. Although the agricultural sector is only about 2% of GDP, it tends to add volatility to growth. According to the Department of Water and Sanitation, national dam levels were 60% full as at 13 January, down compared to 64% same time last year. Data by the South African Weather Service show that rainfall in the optimal summer planting season (October and November) in key maize farming provinces was small. In the Q4 Agbiz/IDC Agribusiness Confidence Index, farmers expressed concern that the current drought could negatively affect plantings in the 2019/20 season and thus overall agricultural activity. Despite these concerns, Crop Estimates Committee data show that intentions to plant summer crops for the production season 2019/20 are up 7.4% y/y. However, to get a good grip on activity in farms, the preliminary area planted data for summer crops from the Crop Estimates Committee, due out in late January, will be a key read.

We forecast GDP growth of 0.9% y/y in 2020, compared to an estimate of 0.3% in 2019

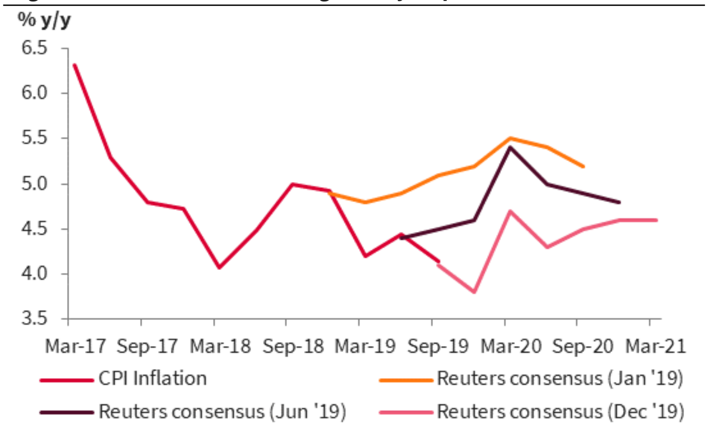
Against this, we forecast GDP growth of 0.9% y/y in 2020 compared to our forecast of 0.3% for 2019. The 2020 forecast is lower by 0.5pp compared to our previous forecast. GDP growth is likely to remain depressed in the medium term mainly due to the slow implementation of growth supporting policies that would lift business spending, a constrained consumer and ongoing episodes of power rationing. We forecast GDP growth to stabilise at a fairly depressed level of 1.2% y/y in 2021 and 2022 (both 0.2pp lower than our previous forecast). Additionally, we see the risks to these forecasts tilted to the downside.

Inflation: still broadly contained but more uncertainty around future path

CPI inflation hit a nine-year low of 3.6% in November but this is likely a low point in this cycle

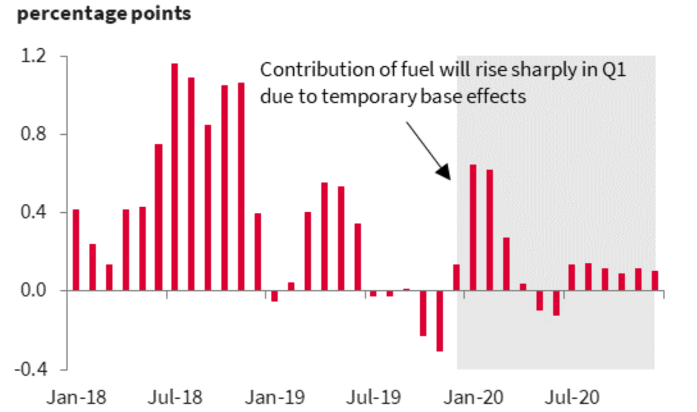
South Africa's recent inflation data have been quite muted, generally surprising the market to the downside. A year ago, the Thomson Reuters Econometer survey consensus forecast for headline CPI inflation for 2019 was 5.2%, but in fact CPI inflation averaged 4.1% in the first 11 months of last year, a bit more than a full percentage lower than expected at the start of the year (Figure 10). One major factor that was not fully anticipated was the extent to which the weak demand environment and persistent spare capacity in the economy would filter through to firms' pricing behaviour. Across the CPI basket, most prices that are sensitive to competitive market forces have been broadly contained. This is most evident in core CPI inflation, which eased to just 3.9% y/y in November, the first sub-4% print since December 2011. Meanwhile, headline CPI inflation hit just 3.6% y/y, its lowest level in nearly nine years. However, we believe the November print represents a low point in this cycle. Both core and headline CPI inflation are likely to increase modestly in the near term, but we think there is more uncertainty than usual around the longer-term path outlook.

Figure 10: Headline inflation has generally surprised to the downside



Source: Stats SA, Thomson Reuters, Absa Research

Figure 11: Fuel inflation set for a sharp but temporary rise in Q1 20

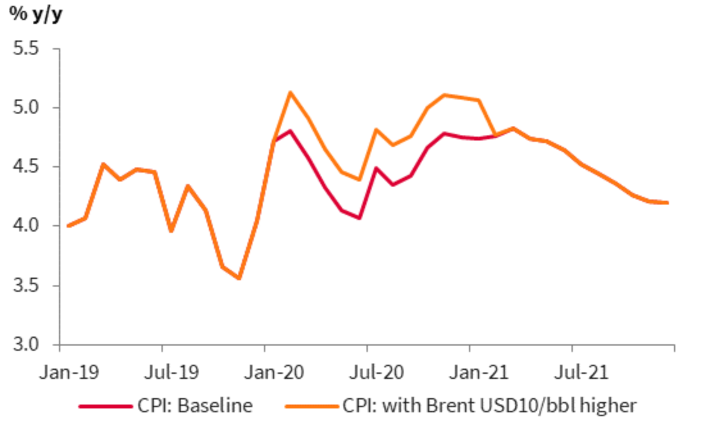


Source: Stats SA, Absa Research

Base effects on fuel are likely to push headline CPI inflation higher in Q1 20

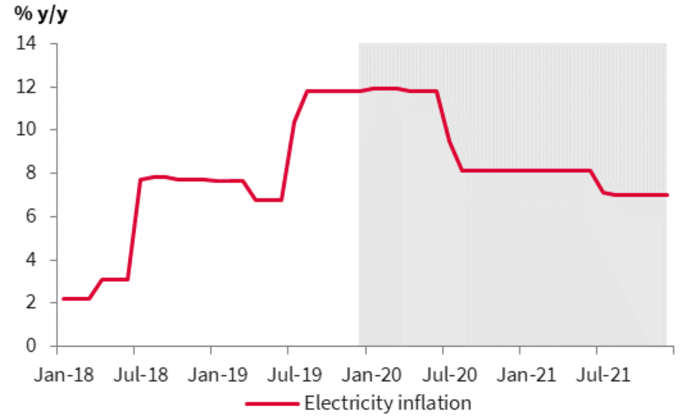
A key driver of an increase in headline CPI inflation in the near term will be fuel inflation, primarily because of base effects. Just based on the already available fuel price adjustments to January, fuel price inflation will hit about 14.4% y/y in January and therefore add 0.7pp to headline inflation, up from -6.6% in November when it subtracted 0.3pp off headline inflation (Figure 11). Beyond this, the path of Brent crude oil prices will be key. Based on Bloomberg consensus data available at the time of calibrating our model, we have assumed Brent crude oil prices of around USD60/bbl for Q1 20 and through to year-end. However, the recent increase in Brent crude oil prices following a flare-up in tensions between the US and Iran could be an upside risk to the inflation outlook if sustained. A USD10/bbl deviation from our baseline assumption that is sustained over the year would imply a 0.3pp difference in headline CPI inflation, before accounting for indirect effects (Figure 12). There is also a high degree of uncertainty around electricity tariffs. Although we have assumed average increases of 10.0% in 2020 and 6.6% in 2021 (Figure 13), in line with the MYPD4 determination, court proceedings over Eskom's challenge to the National Energy Regulator of South Africa's (NERSA) recent decisions, due to start this month, are a big upside risk, possibly even for as early as this year if the courts quickly rule that NERSA was wrong to claw back the National Treasury's R69bn bailout via a lower tariff.

Figure 12: Brent crude oil prices are key for the CPI inflation path



Source: Stats SA, Absa Research

Figure 13: Electricity tariff hikes will remain steep and with upside risks

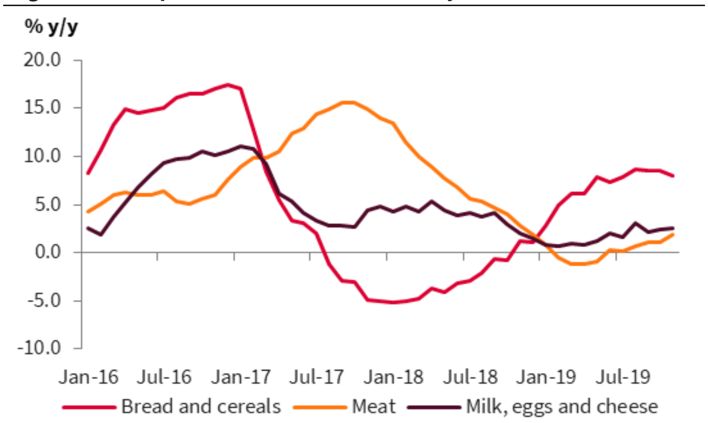


Source: Stats SA, NERSA, Absa Research

Food inflation path will depend on the effect of FMD on meat prices and the size of domestic harvest in 2020

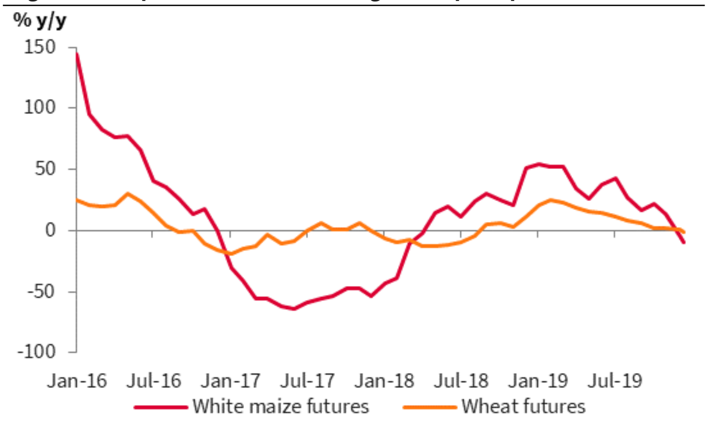
The path of food inflation is also critical given the relative size of this category in the CPI basket. Recently, food and non-alcoholic beverages inflation has been exceptionally muted and unusually stable, printing at just 3.5% y/y in November after having risen to 3.9% in August and September. We believe food inflation will remain subdued in the near term for two reasons. Firstly, the agricultural authorities detected another breakout of foot and mouth disease (FMD) late last year, resulting in another meat export ban. As a result, meat price inflation could fall anew in the near term (Figure 14). Secondly, for the crop-related parts of the food basket, crop futures prices have remained quite muted (Figure 15), which bodes favourably for near-term food inflation. That said, there is still some uncertainty about the potential summer crop for 2020. Planting intentions for 2019/2020 were about 7.3% higher than that in 2018/2019 but rainfall in key summer-crop-growing regions has been uneven. The first indication of the area planted for the 2019/20 summer crop will only be available on 29 January when the Crop Estimates Committee releases the data.

Figure 14: Food price inflation has been broadly contained



Source: Stats SA, Absa Research

Figure 15: Crop futures are not showing much upside pressure



Source: Refinitiv, Absa Research

We expect some upward pressure from a likely VAT increase but pass-through could be low

Given South Africa's ongoing fiscal challenges, we expect the government to lift indirect taxes in an effort to earn more revenues, and this carries implications for the inflation outlook. In our forecast, we have assumed that the government will raise the general fuel levy by 30cents/litre. But more importantly, we expect the government to increase the VAT rate by 1pp to 16% in the 2020 Budget. By our calculations, some 65% of the headline CPI basket is subject to VAT after controlling for zero-rated and exempt items (i.e., some food items, rentals, education and public transport). Meanwhile, we find that 71% of core CPI is subject to VAT, although we note that Stats SA does not survey all items of the CPI on a monthly basis. In a full pass-through scenario, the VAT increase would add 0.4pp to headline CPI inflation in 2020 and 0.2pp in 2021. However, given the recent experience where some retailers absorbed the 2018 VAT increase into their margins, we think pass-through may again be only partial.

Housing costs are a big part of the CPI basket and are key to watch, with the December CPI print due out soon containing the latest quarterly survey

While there is a fairly high degree of uncertainty around some of the supply-side drivers of inflation and possible fiscal shocks to inflation, one underlying theme which is likely to persist is the lack of demand-pull pressure on inflation. The effects of this have been evident across the CPI basket, including in large categories such as housing inflation (which accounts for 16.8% of the CPI basket), where rental inflation fell to a low of 3.3% y/y and owners' equivalent rent fell to 2.6% y/y in the September survey. The December survey will only be published on 22 January, and will be key to watch; anecdotal evidence suggests continued downward pressure on housing costs. More generally, both core goods inflation and core services inflation have not shown any material upside pressure.

We forecast headline CPI inflation of 4.4 in 2020 with a near-term average peak of 4.6 in Q1 2020

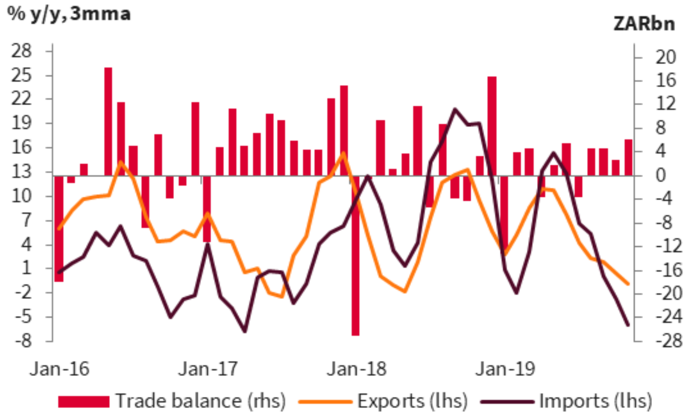
Taking all of these factors into account, we forecast headline CPI inflation will rise in the near-term, reaching a local peak of 4.6% y/y in Q1 20 before moderating to reach 4.4% by Q4 2020 and averaging 4.6% in 2021. We forecast core CPI inflation to average 4.3% in 2020 and 4.4% in 2021. But also key to this inflation forecast is the assumption that the rand will weaken to about 15.47/USD by the middle of the year and further to 16.13/USD by year-end. There is also a debate about what the possible effects of a Moody's credit ratings downgrade (which is now our baseline expectation) could be for the exchange rate, how long this could be sustained and what the pass-through from such exchange rate depreciation would be on inflation. This remains a further material risk to our inflation forecast profile. Therefore, while we expect headline CPI inflation to remain well within the 3-6% target range and mostly around the mid-point of the target, we see a much higher degree of uncertainty around the key inflation risk factors and therefore the future path of CPI inflation.

Persistent current account deficit despite weak domestic demand

South Africa's persistently large deficit on invisible flows will likely continue to deliver current account deficits averaging between 3% and 4% of GDP

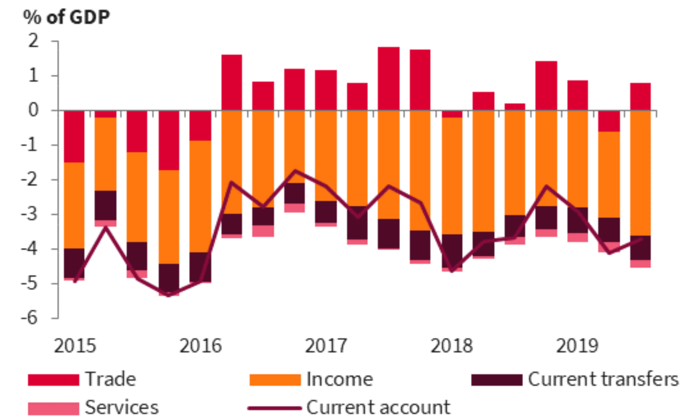
The merchandise trade balance has improved markedly in recent months as imports have contracted faster than exports (Figure 16). The resulting improvement in the monthly merchandise trade balance after the current account deficit came in at R62bn (equivalent to 3.7% of GDP after seasonal adjustment) in Q3 19 may see the seasonally adjusted deficit fall just below 3% in Q4, depending, of course, on the balance in the December merchandise trade data to be released at the end of this month, as well as the net balance on invisible flows (the data for which are only released quarterly). However, in general, we believe that South Africa's structural deficit with respect to invisible balance of payment flows (which arises more from income flows than service payments and receipts) will likely ensure that the current account deficit continues to average between 3% and 4% of GDP, despite weak domestic demand (Figure 17).

Figure 16: Imports are contracting faster than exports



Source: SARS, Absa Research

Figure 17: South Africa runs a persistently large deficit on income flows

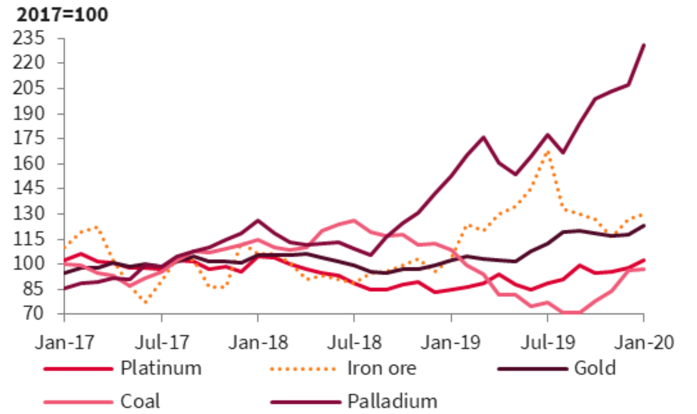


Source: SARB, Absa Research

Precious metal prices have risen sharply, but so have crude oil prices, making it difficult to call exactly where the terms of trade will net out

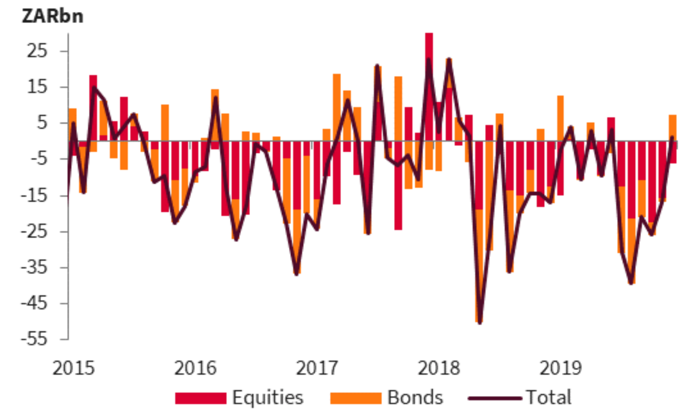
Going forward into 2020, the terms of trade are likely to be a key determinant of the current account balance, with recent Middle East tensions between the US and Iran having sharply pushed up prices of both oil (which accounted for 10% of South Africa's merchandise imports between January and November 2019) and gold and platinum group metal prices (5% and 9% of exports, respectively, over the same period). Brent crude oil prices are up 3.8% since the end of Q3, while gold has risen 5.4% and platinum (which accounts for 50% of South Africa's PGM production) and palladium (30%) by 14.5% and 38.1%, respectively (Figure 18).

Figure 18: Skyrocketing palladium prices should help terms of trade



Source: Eikon, Absa Research

Figure 19: JSE-based portfolio flows have been steadily negative



Source: SARB, JSE, Absa Research

JSE data show sizeable net foreign sales of equities and bonds and this trend could continue in 2020, but other capital inflows may offset this to a significant degree, as they did in Q3 19

South Africa's persistent current account deficit leaves South Africa reliant on a continual inflow of foreign capital for financing. However, JSE-based data on portfolio capital inflows have continued to disappoint, with net sales of R118bn of equities and R26bn of South African local currency bonds for a total outflow at R144bn, just a touch higher than 2018's R142bn (Figure 19). In 2020, the possibility of a credit rating downgrade from Moody's and the loss of South Africa's last remaining investment grade rating raises the probability of further big bond portfolio capital outflows, as South Africa is ejected from the World Government Bond Index. We also believe the MSCI equity index re-weightings to include China possibly point to further net equity outflows. Of course, as the exchange rate weakens and asset prices fall in South Africa, South African investors may decide to repatriate some of their sizeable offshore investments, and some portfolio inflows are not captured in the JSE data. Although JSE data show net foreign sales of South African bonds and equities in Q3 2019, the SARB balance of payments data point to a net overall portfolio capital inflow of R75bn, which reflects in part the USD5bn Eurobond issue, along with net 'other' investment inflows, including bank deposits, of R84bn.

Fiscal position remains precarious

After presenting a projected main budget deficit of 6.8% of GDP for FY20/21 in the 2019 Budget, we believe the government will introduce some corrective measures in the 2020 Budget at end February

The Medium-Term Budget Policy Statement (MTBPS) in October forecast a main budget deficit outcome of 6.2% of GDP in FY19/20, rising to 6.8% of GDP in FY20/21, equivalent to a primary deficit of 2.6% of GDP, including financial support for Eskom amounting to about 1% of GDP (see *South Africa 2019 MTBPS: Still waiting for the hard decisions*, 31 October 2019 for more details). However, with a real interest rate on government debt that is much higher than the real GDP growth rate, South Africa needs instead to run sizeable primary budget surpluses just to stabilise debt to GDP. We believe the government intends to implement some corrective measures in the 2020 Budget, which will be unveiled on 26 February, but their scale and exact modalities are still up in the air, especially with regard to the relative balance between reliance on expenditure cuts versus tax increases.

We believe that there is little prospect of sizeable further expenditure cuts

In June last year, the National Treasury called for 5% mandatory cuts in baseline budgets from national and provincial government departments, but such large spending cuts were not embedded into the MTBPS projections. The National Treasury has warned of the pressing need to curtail spending on public sector compensation, but with employee compensation accounting for 34% of total planned (consolidated) spending in FY19/20, we believe the scope for big cuts is limited, given that the government is in the middle of a multi-year pay deal with civil servants, which ends only in March 2021, and it has also promised not to implement any mandatory retrenchments. The ability of the government to use natural attrition and reboot its early voluntary retirement mechanism to downsize the public sector wage bill looks tenuous, while the idea of eliminating automatic notch progression for pay will need to be negotiated with unions as well. Other important components of total spending, such as social grants (over 9% of total spending) and the interest bill (11%), also cannot be cut, and there is a limit to how much the government's capital investment and its transfers to provinces and municipalities can be cut further without negatively impacting service delivery. The MTBPS already announced cuts of R20.3bn in transfers to the provinces over the three years commencing in FY20/21, while transfers to local government are to be cut by R20.5bn, in part to make room for extra funding for Eskom. Furthermore, bailout demands from other troubled state-owned companies (SOCs) are likely to continue, with the government having subsequently announced a further R2bn for South African Airways. Overall, we assume roughly R20bn of additional spending cuts to be announced for the upcoming fiscal year.

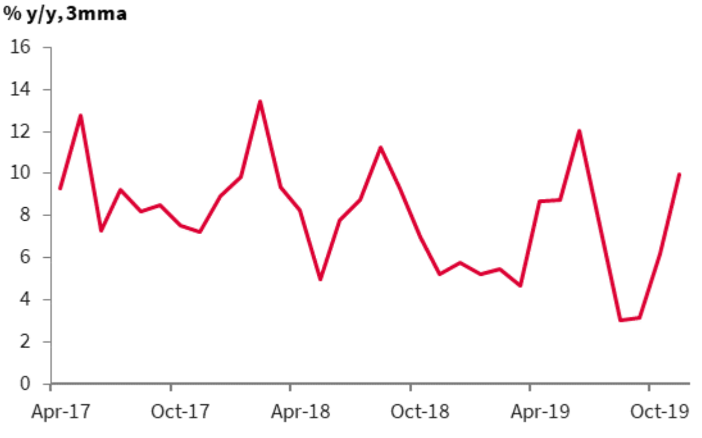
We expect tax increases of about R35bn or so, including a 1pp hike in VAT

Instead, contrary to earlier hints from the National Treasury that there is little economic scope for further tax increases, we believe the fiscal adjustment effort will rely significantly again on the revenue side of the fiscus. The 2019 Budget announced R10bn in tax increases for FY20/21 with full details to be unveiled in the 2020 Budget, but we believe given Eskom's financial requirements and the urgency of action against South Africa's slippery debt dynamics, the 2020 Budget could go somewhat further. We forecast a 1ppt VAT increase to 16% and some recourse again to inflationary bracket creep on personal income taxes, plus a mix of smaller tax adjustments, for a total take of roughly R35bn or so. Our call of a VAT hike is perhaps a bold one, given the likely political fallout, but it is difficult to see what other options the government has. Further increases in personal income tax rates would likely damage the tax base. Over the longer term, the institutional rehabilitation of the South African Revenue Service (SARS) should serve to boost tax buoyancy, but this will take time to entrench.

We think the deficit in the current fiscal year will be bigger than National Treasury expected in the MTBPS

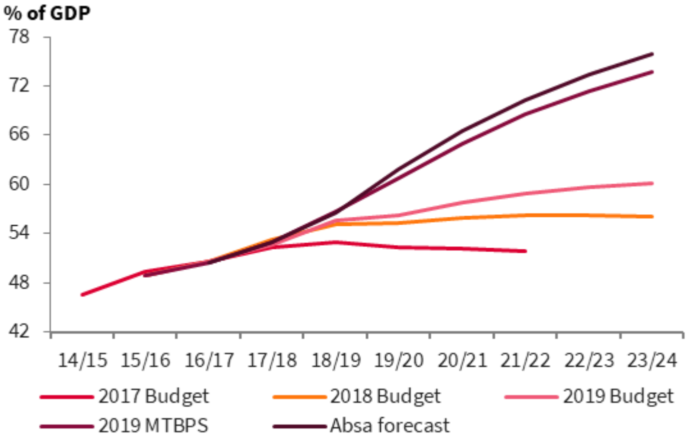
We now are more bearish on the likely deficit outcome for the current fiscal year, given the weakness of GDP, and its knock-on consequences for tax collections. We forecast a main budget deficit of 6.9% of GDP in FY19/20 compared to the MTBPS projection of 6.2% of GDP. Positively, the pace of personal income tax collections has picked up again after a dip in Q3 19 (Figure 20). Looking into next year, our expectation that Finance Minister Mboweni and National Treasury will deliver some additional tax hikes and expenditure cuts in the 2020 Budget translates into forecasts with somewhat lower main budget deficit and debt numbers in rand terms. However, our weaker outlook for nominal GDP leave the deficit and debt ratios quite elevated (Figures 21 and 22).

Figure 20: Personal income tax collections are holding up



Source: National Treasury, Absa Research

Figure 21: Weaker nominal GDP path pushes up debt ratios



Source: National Treasury, Absa Research

Public indebtedness is likely to continue rising

Public debt is likely to continue rising. The MTBPS projected that, including the planned financial support from the fiscus to Eskom, gross debt to GDP could rise to nearly 65% of GDP by the end of FY20/21, and would trend up sharply on current policies and growth prospects to nearly 81% by FY27/28, even without the likely transfer of a significant portion of Eskom's balance sheet liabilities to the government's balance sheet. A comprehensive restructuring of both sides of the government's balance sheet would be one obvious answer, but the concept of outright privatisation remains anathema to large parts of the government and the African National Congress (ANC). The government's plan to try to attract minority private equity partners into some of its strategic state-owned companies does not seem likely to garner a lot of interest, in our view, while a plan to dispose of 'non-core' assets has been mooted for many years with little discernable progress towards identifying which SOCs are not strategic. A viable path towards fiscal consolidation and debt stabilisation thus remains elusive, and market participants will be watching the 2020 Budget closely.

Figure 22: Public indebtedness likely to continue rising over the medium term

National Treasury 2019 MTBPS	2016/17	2017/18	2018/19	2019/20F	2020/21F	2021/22F	2022/23F
Real GDP, % y/y	0.8	1.3	0.6	0.9	1.2	1.6	1.8
GDP deflator, % y/y	6.3	5.0	4.1	4.9	4.9	4.9	4.7
Nominal GDP, ZARbn	4419	4699	4922	5211	5530	5893	6283
% change	7.1	6.3	4.7	5.9	6.1	6.6	6.6
Tax buoyancy	0.98	1.00	1.23	1.08	1.09	0.99	1.00
Gross tax revenue, ZARbn	1144.1	1217	1288	1370	1461	1556	1658.2
% change	6.9	6.3	5.9	6.4	6.7	6.5	6.6
Total main budget revenue, ZARbn	1137.9	1196.4	1274.7	1359.1	1425.9	1525.6	1627.9
Revenue shortfall (vs 2019 Budget targets), ZARbn				-53	-84	-115	
Expenditure, ZARbn	1306	1405	1507	1683	1801	1910	2018
Interest costs, ZARbn	147	163	182	204	233	265	299
Support for Eskom, ZARbn				50	62	44	37
Main budget deficit, ZARbn	-168	-209	-232	-324	-375	-384	-390
Main budget balance, % of GDP	-3.8	-4.4	-4.7	-6.2	-6.8	-6.5	-6.2
Primary balance, % of GDP	-0.5	-1.0	-1.0	-2.3	-2.6	-2.0	-1.4
Main budget balance excl. support for Eskom, % of GDP	-3.8	-4.4	-4.7	-5.3	-5.7	-5.8	-5.6
Gross debt, ZARbn	2233	2490	2788	3168	3591	4036	4478
Gross debt, % of GDP	50.5	53.0	56.7	60.8	64.9	68.5	71.3
Absa Research forecast Q1 2020							
Real GDP, % y/y	0.8	1.6	0.4	0.5	0.9	1.2	1.2
GDP deflator, % y/y	6.2	4.8	4.3	3.5	3.8	4.2	4.1
Nominal GDP, ZARbn	4420	4702	4925	5123	5361	5654	5955
% change	7.1	6.4	4.7	4.1	4.7	5.5	5.4
Shortfall to MTBPS target, ZARbn	0	4	4	-88	-169	-240	-328
Total main budget revenue, no tax policy change ZARbn	1138	1196	1275	1331	1400	1476	1555
Absa forecast: tax hikes to be introduced in 2020 Budget, ZARbn	0	0	0	0	35	15	15
Total main budget revenue after tax policy changes, ZAR bn	1138	1196	1275	1331	1435	1528	1624
Tax buoyancy	0.98	1.00	1.23	1.08	1.64	1.18	1.18
Absa forecast: spending cuts to be announced in 2020 Budget					20	40	45
Main budget expenditure, ZARbn	1306	1405	1507	1683	1781	1870	1973
Deficit	-168	-209	-232	-352	-346	-342	-348
as % of GDP	-3.8	-4.4	-4.7	-6.9	-6.5	-6.0	-5.8
Debt	2233	2490	2788	3168	3562	3965	4365
as % of GDP	50.5	52.9	56.6	61.8	66.4	70.1	73.3

Source: National Treasury, Absa Research

Monetary policy: a difficult balancing act but path will be highly data dependent

Monetary policy decisions will likely continue to follow a meeting-by-meeting risk assessment rather than a cycle

South Africa's monetary policy calculus has become a lot more complicated in recent years. This is not only because of the monetary policy committee's shift to prefer anchoring inflation expectations around the 4.5% mid-point of the target range and the uncertainty about the speed of adjustment in this regard, but also due to the increased need for the MPC to factor in hard-to-quantify risks, both domestic and international. MPC members have not always agreed on how to balance these various factors, resulting in a number of split-vote MPC decisions (Figure 23). At its November 2019 meeting, the MPC decided to keep the repo rate on hold but 2 of the committee's 5 members preferred a 25bp cut while the rest preferred the repo rate to remain unchanged. The MPC statement for that meeting acknowledged the improvement in the inflation outlook but was still relatively hawkish in tone, stressing the risks of future market volatility and elevated uncertainty about the risks to the inflation outlook. However, since then further significant improvements in the inflation outlook and a deterioration in South Africa's growth prospects motivated the MPC to vote unanimously to cut the repo rate by 25bp to 6.25% at its January 2020 meeting. The shift from November underscores the high degree of data-dependency in the MPC's decisions from one meeting to another. Against this backdrop, forecasting the path of monetary policy, especially over long horizons has become a lot more difficult. Looking ahead, monetary policy decisions seem likely to continue to follow a meeting-by-meeting reassessment of risks rather than any clearly defined and communicated rate cycle.

Fiscal imbalances remain a major constraint for monetary policy

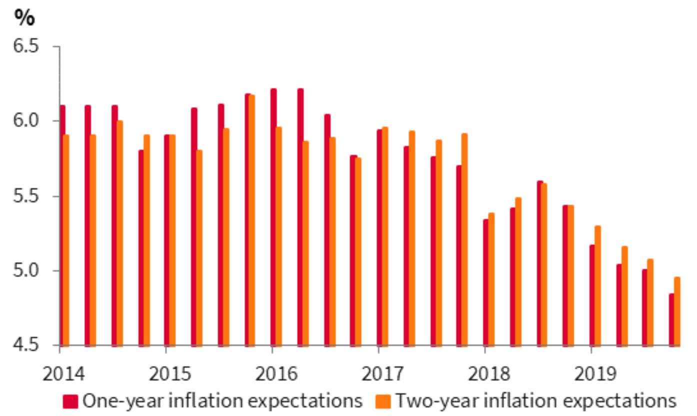
One big risk factor that has clearly been of significant concern to the MPC is the deterioration in South Africa's fiscal imbalances. Linked to this is the risk that South Africa could lose its investment-grade credit rating with Moody's, lifting the risk premium and triggering portfolio outflows and exchange rate depreciation. Governor Kganyago has also been increasingly vocal on his concerns about fiscal dominance in speeches and recent MPC Q&A sessions. We believe that concerns about fiscal policy will remain top of mind for this MPC, particularly given that four of the current five members are former National Treasury employees. Thus, unless the National Treasury can produce a Budget that tables a credible path towards fiscal consolidation, the SARB MPC will likely continue to see fiscal policy as a constraint that necessitates caution. As we have argued, we believe that the 2020/21 Budget is likely to be underwhelming in terms of fiscal consolidation and we think the MPC will likely want to wait to see the Moody's ratings action, which is due a week after the March MPC meeting.

Figure 23: MPC voting outcomes in the last three years

MPC Meetings*	2017	2018	2019	2020
January	6/0[NC]	5/1[NC]	6/0[NC]	5/0[C]
March	5/1[NC]	4/3[C]	6/0[NC]	-
May	5/1[NC]	7/0[NC]	3/2[NC]	-
July	4/2[C]	7/0[NC]	5/0[C]	-
September	3/3[NC]	4/3[NC]	5/0[NC]	-
November	6/0[NC]	3/3[H]	3/2[NC]	-

**Note: *NC - no change; C - cut; H – hike; Source: SARB, Absa Research*

Figure 24: The MPC wants to see inflation expectations around 4.5%



Source: BER, Absa Research

SARB has stressed its preference to have inflation expectations anchored sustainably around 4.5%

While South Africa's yawning fiscal imbalances are an ongoing risk, there are other developments that the MPC will likely see as favourable. In particular, the SARB has in the recent past stressed in MPC statements that it would like to see inflation expectations, as opposed to actual inflation outcomes, anchored more firmly closer to the mid-point of the target range. Positively, survey-based measures of inflation expectations have continued to ease, edging closer to the mid-point of the target range. The Q4 19 BER Inflation Expectations survey shows that average one-year

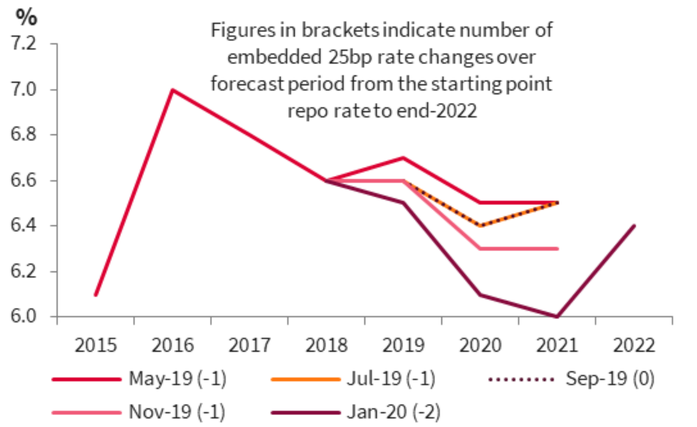
We expect the MPC to keep rates on hold but see risks skewed in the direction of some easing

expectations eased below 5% for the first time since 2007, settling in at 4.8% in Q4 19, just down 0.2pp from Q3 19. Two-year expectations also eased marginally by 0.1pp to 5.0% in Q4 19. Five-year inflation expectations also softened further in Q4 19, falling by 0.1pp to 4.9%, the lowest reading for this tenor since 2011, when the BER included it for the first time in the inflation expectations survey. Notably, inflation expectations generally softened across all surveyed social groups. However, it is worth noting that survey-based inflation expectations tend to be adaptive, rather than forward-looking. Therefore, these could edge higher in the coming survey as headline CPI inflation prints rise into Q1 2020. Our baseline forecast is for the MPC to keep the repo rate on hold for the foreseeable future. However, just like the MPC decisions, our call is a finely balanced one and also highly data-dependent. The uncertainty around the Moody's credit ratings decision will be a key consideration. At the Q&A session of the January MPC media briefing, Governor Kganyago was reluctant to be drawn into a discussion about the committee's thinking about the likely effect of a Moody's credit ratings downgrade, saying only that the MPC would react to it as it does to any other shock: only to the second-round effects of any sudden capital outflow and exchange rate depreciation, as opposed to either trying to preempt the action, or responding immediately to its first-round impact. That said, even with our expectation that Moody's is more likely than not to lower South Africa's sovereign credit ratings, we still see risks skewed somewhat slightly in favour of further easing rather than tightening for two reasons. Firstly, we think headline CPI inflation is likely to be lower than the SARB expected at its January meeting. Secondly, we think there are further downside risks to the SARB's GDP growth forecasts. Further downward revisions in the future would serve to bias the SARB's Quarterly Projections Model (QPM) towards more easing.

The QPM and the FRA market both indicate further easing

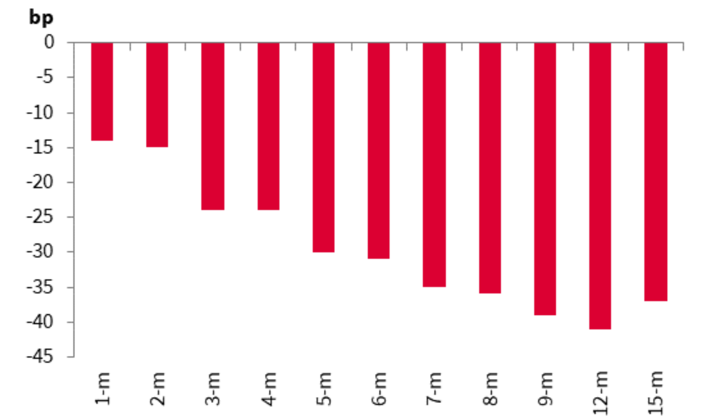
The QPM run prior to the January meeting projected two rates cuts (Figure 25). Although the SARB regularly stresses that the QPM is only a broad policy guide, we think that it is an important disciplining mechanism for rate decisions and that the committee would find it increasingly difficult not to move if the QPM again embeds two or more rate cuts at some point in the future. That said, it is notable that the QPM projected tightening of nearly 50bp in 2022. Although this strikes us as somewhat odd, in the context of the SARB's inflation and growth forecasts for that year, we believe it could curb the committee's enthusiasm to deliver further cuts. At the time of writing, the FRA market is discounting another 25bp rate cut by September this year and some 31bp of easing in total until January 2021 (Figure 26).

Figure 25: November QPM calibration embedded one rate cut in 2020



Source: SARB, Absa Research

Figure 26: FRA market is also fully discounting one cut in 2020



Source: Refinitiv, Absa Research

The ZAR is likely to weaken back up to R15 handle

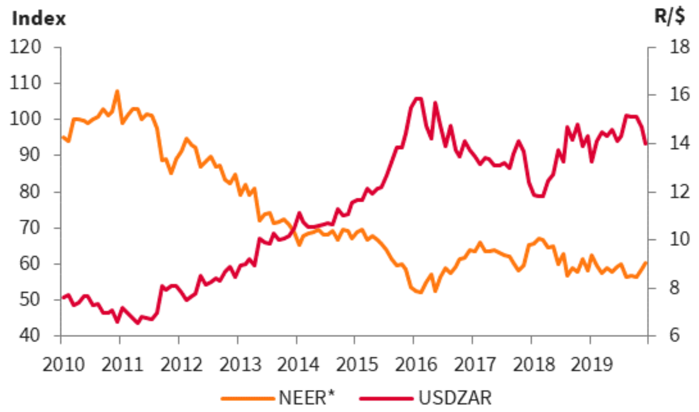
We expect the ZAR to weaken

We expect the ZAR to weaken to R15.16/USD by the end of Q1 20 and reach R16.13/USD by year-end (Figure 28). Both our structural ZAR model, which estimates the fair value of the exchange rates based on SA's current account balance and the country's interest rate differentials (See *Strategy Insight: Our Structural model also implies the ZAR is too strong,* 20 January), and our Peer model, which compares the ZAR to other high-yielding and commodity-based currencies, imply the ZAR is currently overvalued.

The Moody's rating decision leaves the rand particularly vulnerable but various other possibilities could see it outperform or underperform our forecasts

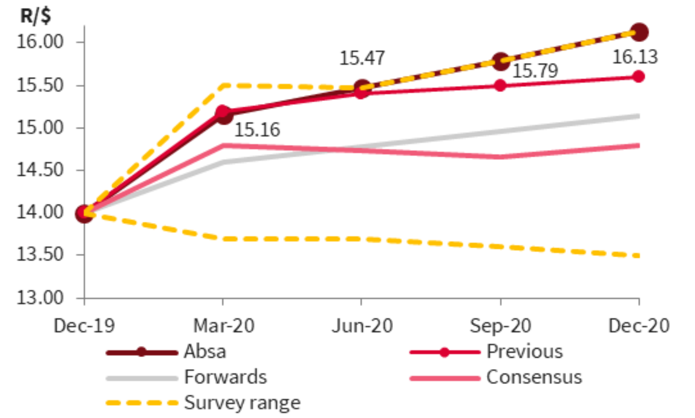
We expect the ZAR to be particularly vulnerable to capital outflows during the first half the year because we believe Moody's is likely to downgrade South Africa's local currency credit rating in March (which in turn will eject SAGBs from the World Government Bond Index) at the end of March, while JP Morgan is scheduled to further reduce South Africa's bond weighting within its emerging market bond index during the first half of 2020. The ZAR could actually weaken by more than we expect if the SARB cuts policy rates by more than the market currently expects and/or the economy falls back into recession. Conversely, the ZAR might prove to be more resilient than we believe if global volatility levels continue to subside on the back of reduced global trade tensions, which in turn could rekindle the ZAR's carry trade appeal. Any further improvement in South Africa's terms of trade might also support the ZAR.

Figure 27: Historical exchange rate trends



** NEER represents nominal effective exchange rate. Source: Bloomberg, Absa Research*

Figure 28: Comparative USDZAR projections



Source: Bloomberg, Absa Research

Eskom remains a huge weight on the fiscus and on the economy generally

The spectre of ongoing load shedding will continue to haunt the South African economy in 2020, but quantifying its likely impact is difficult

The return of load shedding at the beginning of December (in an intense and extended way), and again in early January (so far moderately and briefly), is an unwelcome reminder that Eskom's ongoing operational challenges, especially in generation, remain a severe downside risk to Eskom's finances, the fiscus, and South Africa's growth prospects. Eskom's energy availability factor (EAF), which is the proportion of its theoretical generating capacity that is actually available at any given time, fell to new lows towards the end of 2019 (Figure 30) as unplanned outages (breakdowns) mounted. With electricity demand likely to ramp up sharply in the second half of January as businesses and factories return to work, the prospect of further load shedding remains high, until such time as Eskom makes a lot more progress in rehabilitating its existing plant and/or procuring new supply. However, Eskom's chief operating officer, Jan Oberholzer, said in early January that Eskom is mulling over a new maintenance strategy, to be considered by the board before the end of January, which would prioritise creating sufficient headroom for intensive maintenance over a couple of years, such that the utility could only deliver a minimum power supply of about 25,000MW, which is about 5000MW short of the current 'normal' demand, raising the risk of ongoing regular load shedding. However, even without this new 'stricter maintenance' strategy, there are ongoing risks of load shedding. Unplanned outages as of the morning of 17 January stood at 11,374MW, well above the 9,500MW level at which the utility says it can comfortably meet demand without having to resort to the emergency water and diesel reserves at its pumped storage and open cycle gas turbine generators.

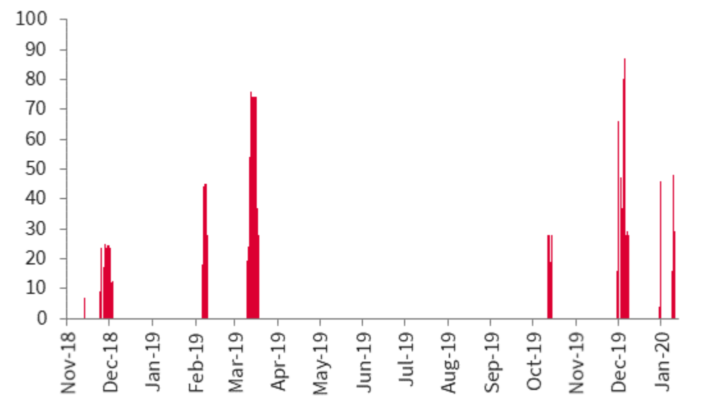
Procurement of new generating plant is key

In mid-December, the Department of Mineral Resources and Energy (DMRE) issued a request for information for emergency power procurement and demand-side measures of 2000-3000MW that could be quickly operationalised. Proposals are due by 31 January. However, the government has not yet announced a fifth procurement round from independent renewable energy producers nor moved forward on proposals to liberalise small-scale embedded generation, which the solar photovoltaic power association said could deliver 2000MW of power over 12 months. The government has hinted at action on these fronts, but at this stage, it remains uncertain.

It is hard to predict the frequency and intensity and duration of the load-shedding constraint

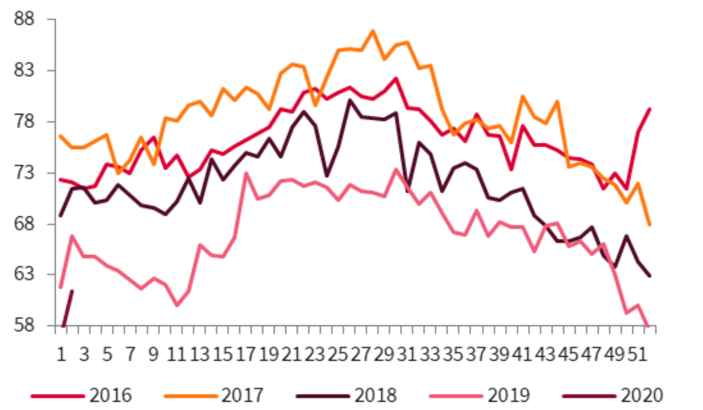
Overall, predicting the timing, duration and intensity of possible load shedding events in 2020 and beyond is very difficult, and thus we cannot explicitly embed it into our macroeconomic forecasts, but it remains a persistent downside risk to growth, while the costs of shoring up the faltering utility financially are an adverse risk to the government's fiscal performance. Another Eskom-related issue to watch closely in the coming months is Eskom's progress towards functional separation of its generation, transmission and distribution businesses, targeted by end-March. Our in-depth look at Eskom published on 9 December (*Eskom SOC Ltd: Still a lot more questions than answers*) takes a detailed look at these issues.

Figure 29: Load shedding has resumed early in 2020



Source: Eskom, Absa Research

Figure 30: The energy availability factor fell sharply over 2020



Source: Eskom, Absa Research

Some acceleration of structural reform at end-2019 but 'to-do' list is daunting

Under President Ramaphosa, South Africa has made progress in rolling back state capture

There is a widespread agreement that South Africa needs a range of structural reforms to improve the business climate, catalyse more investment and boost the country's stuttering growth rates. As we argued in the last *Quarterly Perspectives*, President Ramaphosa has made a fair amount of progress in strengthening the institutions of the state that were most corroded by state capture. In particular, the additional funding announced for both South African Revenue Service and the National Prosecuting Authority (NPA) in the MTBPS should go some way to enabling the institutions to rebuild, after the new leadership was announced earlier in the year. Additionally, towards the end of last year, the NPA initiated a number of arrests, including some Eskom officials and linked businessmen, and a former state security minister. We believe more arrests and prosecutions are likely in 2020, and this should help sentiment somewhat. However, we think that cleaner and more effective governance is likely a 'necessary but not sufficient condition' to lift South Africa out of the economic doldrums.

Structural reform momentum picked up towards end-2019 but progress is not fast or broad enough yet to have an appreciable effect on sentiment or growth rates

In addition to clean governance, South Africa needs better economic policies in the form of structural reforms across a broad set of activities and sectors. Unfortunately, progress here has been slow overall, leading to a chorus of complaints from businesses and investors. That said, momentum did appear to pick up towards the end of 2019, with the publication of an unbundling strategy for Eskom, the long-awaited update of the Integrated Resource Plan to guide South Africa's electricity sector development up until 2030, the unveiling of a water master plan, the launch of the Tourism Safety Initiative and the release of a discussion document on the licensing process for spectrum allocation (open for public comment until the end of this month). However, frustrations continue to mount about a perceived slow pace of change, especially in South Africa's energy sector where President Ramaphosa has promised new measures to procure additional sources of electricity, but Minister Mantashe appears not to be moving quickly to lifting regulatory obstacles to business' own generation or in launching a fifth procurement round for renewable energy.

Political opposition to painful structural reforms is likely to remain elevated

As we argue in our analysis of South Africa's difficult political dynamics, opposition to President Ramaphosa from within the party is one key obstacle to a more aggressive reform path. A lack of capacity within the public sector is another. However, as we argued in the last Quarterly Perspectives 'U-turns are rarely V-shaped'. Even when structural reform does not require much financing and/or is not strongly contested, it takes time to conceptualise, design and implement well. Still, the relative lack of progress is further evidenced by a series of tweets from no less a person than South Africa's own Finance Minister, Tito Mboweni, who recently used his personal social media account to complain of 'structural reform inertia', saying that it would be 'game over' for South Africa without deep structural reforms. Mboweni referred to the National Treasury's growth strategy paper, a final version of which was published at end October, laying out the necessary economic reforms and further cautioned that South Africa had 'no time for procrastinating'.

The most difficult and painful reforms are also the ones that are most necessary to right the ship

In Figure 31 below, we have attempted to categorise various structural reforms by both their progress level and degree of challenge (because implementing them is logistically complicated, and/or there is political opposition to them, and/or they require hefty financing). Unsurprisingly, some of the most challenging reform ideas, many of which have not even been adopted by the government as policy, are also the ones that we think would most appreciably move the needle on sentiment and growth, such as privatising loss-making state-owned companies or liberalising labour markets. In general, we see 2020 as likely to be a year of slow structural reforms. The three most important reform processes to watch in our view are the unbundling of Eskom, the liberalisation of the energy markets, and the move to broadband spectrum auction.

Figure 31: Structural reform progress has accelerated, but various key reforms are still contested

	Already effected	Underway and possibly imminent	Adopted as policy, but will take time to implement	Not adopted
Relatively Easy	Introduction of secret strike ballots	No exclusivity clauses for big retailers	Better coordinated support for SMMEs	Better communication of ongoing reform progress to lift business sentiment and build momentum
	Updated Integrated Resource Plan published with a big role for renewable energy	Strengthen capacity at SARS	Further measures to improve ease of doing business (e.g., electricity connections, construction permits, ease of tax payments, etc.)	
	New governance for many SOCs incl. Eskom		Auction broadband spectrum (licensing criteria were issued early with 5G component)	
	Better government and business coordination to identify and unblock growth obstacles			
	Put SAA into business rescue			
	Liberalise visa regimes for tourists			
	Tourism Safety Initiative			
	Water permit turnaround times shortened (ease of doing business)			
	BizPortal launched by CIPC, for easier company registration, tax payer registration, Unemployment Insurance Fund registration, etc.			
Challenging	Unbundling roadmap for Eskom published	Launch the public Infrastructure Fund at DBSA (pilot project on student housing expected soon)	Make Eskom financially sustainable	More youth employment incentives and support
		Strengthen NPA and SAPS, with successful state capture prosecutions	SOC mandate reforms	More PPPs across infrastructure
		Liberalise visa regime for skilled immigrants	Address high administratively determined costs	Policies to support a diverse range of service-oriented export activities (e.g., call centers, accounting, medical, construction)
		Free up peri-urban land for housing development and improved public transport	Rationalise and focus on an Industrial Policy Action Plan	
		Competition Commission to tackle cartels	Improve financing and extension services for new farmers	
			Strengthen public procurement as a policy tool to boost industrialisation	
			Agree on a functional Mining Charter 3	
Very difficult	Agree African Continental Free Trade Area		Unbundle Eskom, against the backdrop of broader energy sector reforms	Liberalise labour markets, esp. for SMMEs (e.g., automatic extension of wage deals)
			Create a national water strategy with overarching water regulator and bring the private sector into rehabilitating national water infrastructure	Privatise loss-making SOCs
			Rural land redistribution broadly	Refine Broad-based Black Economic Empowerment rules to lower compliance costs for SMMEs
			National Health Insurance (to be preceded by fixing public health sector)	Forge a workable social compact/fix NEDLAC paralysis
			Improve capacity-building and accountability at municipalities	Shrink public sector payrolls to allow more money for public investment
			Strengthen border logistics to smooth trade flows	Improve port logistics and lower prices
			Legislation for economic regulation of the transport sector	Allow private access to SA's rail network
			Agree and implement regional free trade deals, and implement African Continental Free Trade Area	Overhaul basic education
				Tenure reform in communal lands

Source: Absa Research

Fraught political dynamics to remain a key market consideration in 2020

Parliament will be a key political battleground in 2020 with a number of hot button issues to consider

South Africa's political outlook is likely to remain dominated by the factional divide within the governing ANC, with President Ramaphosa's efforts to roll-back state capture and strengthen constitutional governance meeting resistance from some segments within the party. There are a number of key political dynamics to watch in the coming quarters. The first is the potential parliamentary recall of the Public Protector, Busisiwe Mkhwebane, with the parliament having adopted rules for the procedure to remove the head of a Chapter 9 institutional head, such as the Public Protector, towards the end of 2019. How this proceeds will be an important test of President Ramaphosa's uncertain balance of support in the ANC parliamentary caucus. Another important parliamentary issue is the draft bill for a constitutional amendment to explicitly allow for land expropriation without compensation, with a target date of end-March after public consultation. The parliament's consideration of the National Health Insurance (NHI) legislation will also be a hot political potato, given widespread concerns about how universal health coverage can be funded against a backdrop of strained fiscal circumstances.

Long-awaited action from the National Prosecuting Authorities against those guilty of state capture will also feature heavily in the factional tug of war within the ANC

Outside of the parliament, all eyes will turn to the National Prosecuting Authority (NPA) to see whether it is able to accelerate progress against those guilty of corruption, and whether its actions will tilt the balance of power further in favour of Ramaphosa and his team of reformers. Towards the end of last year, there was a flurry of action, and the NPA head, Shamila Batohi, said that the Estina case, which aims at the heart of the state capture project, would be re-enrolled this year. The parliament's decision to back the dismissal of two key Zuma allies from the NPA late last year should also strengthen the NPA, but further work needs to be done to properly staff and rehabilitate the institution. Former President Jacob Zuma's trial for corruption is also due to resume in April 2020. The Zondo commission of inquiry into state capture is also likely to continue to generate big headlines with expected appearances from President Ramaphosa and the ANC itself. The Zondo inquiry may also subpoena those implicated in state capture to appear before it. Its term is currently due to end in February, but Judge Zondo has said he plans to apply for an extension to December 2020 to appropriately conclude the work.

National General Council around mid-year a key test for President Ramaphosa

Finally, 2020 is the year for the ANC's National General Council (NGC), expected around mid-year. Contrary to some speculation, the NGC does not have the power to recall the president, but it does have the power to review the government's performance in implementing ANC policy resolutions. This could expose President Ramaphosa to a potentially negative review of his performance, which could damage his reputation (and his chances for a second term) if his opponents in the party are able to dominate the process of selecting delegates to the conference. Overall, we think that while President Ramaphosa has been able to make some headway in rehabilitating the institutions of the state and restoring proper governance, opposition from within the party and dysfunctionality in many parts of the bureaucracy will limit his ability to fix South Africa. We assess the balance of political power to have tilted somewhat in Ramaphosa's favour, but not sufficiently to ensure smooth sailing on South Africa's choppy political waters.

Further rating agency downgrades seem likely

We believe Moody's is more likely than not to downgrade South Africa to sub-investment grade in its 27 March scheduled review

Against this backdrop of weak growth, slow structural reform, electricity shortages and large fiscal deficits, further credit rating agency downgrades seem likely. The return of load shedding with its negative implications for growth and for Eskom's finances will also weigh on rating agencies' assessments. All three main credit rating agencies have South Africa on Negative Outlook (Figure 32). Towards the end of the year, both S&P and Moody's announced their biannual schedules for sovereign rating announcements, including South Africa. First up, Moody's, which rates South Africa's foreign currency and local currency debt at Baa3 and is thus the last rating agency with an investment grade rating for South Africa's local currency debt, is due to release its ratings reviews on 27 March and 20 November. S&P, which currently rates South Africa's foreign currency debt at BB and its local currency debt at BB-, will publish on 22 May and 20 November. Fitch, which rates South Africa BB+ does not preannounce its dates. We believe the risk of downgrades in 2020 remains high. We are inclined to view Moody's as more likely than not to act on 27 March, absent a better-than-expected stance in the 2020 Budget or an unlikely pickup in growth momentum, but we think this is probably largely priced into markets already. S&P and Fitch, which moved more recently, could perhaps wait until the second half of the year.

Figure 32: Further downgrades more likely than not this year

	S&P	Moody's	Fitch
Foreign currency	BB	Baa3	BB+
Local currency	BB+	Baa3	BB+
Outlook	Negative	Negative	Negative
Date ratings changed	25-Nov-17	9-Jun-17	7-Apr-17
Date outlook changed	22-Nov-19	1-Nov-19	26-Jul-19
2020 scheduled review dates	22 May and 20 Nov.	27 March and 20 Nov.	Likely late May/early June and late Nov./early Dec.

Source: S&P, Moody's, Fitch, Absa Research

Figure 33: Weaker growth, lower inflation and more difficult fiscal dynamics

	2019				2020				2021								
	Q1	Q2	Q3	Q4F	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F	2018	2019F	2020F	2021F	2022F
Output (% q/q saar)																	
Real GDP	-3.1	3.2	-0.6	0.4	0.9	1.1	1.3	1.6	0.7	1.1	1.5	1.6	0.8	0.3	0.9	1.2	1.2
Real GDP (%y/y)	0.1	1.0	0.2	0.0	1.0	0.5	0.9	1.2	1.2	1.2	1.2	1.2	0.8	0.3	0.9	1.2	1.2
Private consumption	-0.6	2.6	0.2	1.4	0.8	1.1	1.3	1.7	1.0	1.2	1.3	1.8	1.8	1.1	1.1	1.3	1.3
Public consumption	2.0	2.9	1.3	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2	1.9	1.5	0.4	0.2	0.2
Investment	-4.1	5.8	4.6	-5.4	0.5	1.0	1.4	1.6	1.3	1.7	1.6	1.7	-1.4	-0.6	0.4	1.5	1.5
Exports	-27.0	-1.5	3.5	1.6	1.0	1.2	1.4	1.7	1.3	1.4	1.6	1.7	2.6	-2.6	1.4	1.5	1.5
Imports	-5.1	18.3	-6.8	3.8	1.7	1.4	1.5	1.4	1.1	1.3	1.9	2.0	3.3	0.5	1.8	1.4	1.4
Prices (% y/y)																	
CPI inflation	4.2	4.4	4.1	3.8	4.6	4.3	4.5	4.4	4.5	4.6	4.6	4.7	4.6	4.1	4.4	4.6	4.7
Core CPI inflation	4.4	4.2	4.1	3.9	4.0	4.3	4.4	4.4	4.4	4.4	4.4	4.5	4.3	4.2	4.3	4.4	4.5
PPI inflation	5.0	6.2	4.5	2.9	3.5	4.1	4.1	4.4	4.2	4.0	4.2	4.5	5.5	4.6	4.1	4.2	4.8
External and government accounts (% of GDP)																	
Current account	-2.9	-4.1	-3.7	-2.8	-3.5	-3.7	-3.7	-3.8	-4.0	-4.1	-4.2	-4.3	-3.6	-3.4	-3.7	-4.1	-4.3
Main budget fiscal balance*	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	-4.7	-6.2	-6.8	-6.5	-6.2
Main primary balance*	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	-1.0	-2.3	-2.6	-2.0	-1.4
Government debt*	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	56.7	60.8	64.9	68.5	71.3
Interest rates and exchange rate (eop)																	
Repo rate, %	6.75	6.75	6.50	6.50	6.25	6.25	6.25	6.25	6.25	6.25	6.25	6.25	6.75	6.50	6.25	6.25	6.25
Prime rate, %	10.25	10.25	10.00	10.00	9.75	9.75	9.75	9.75	9.75	9.75	9.75	9.75	10.25	10.00	9.75	9.75	9.75
ZAR per USD	14.42	14.11	15.17	14.24	15.16	15.47	15.79	16.13	16.48	16.85	17.24	17.62	14.35	14.24	16.13	17.62	19.02

**Note: fiscal year starting 1 April, e.g. 2019 = FY2019/20, Source: National Treasury, SARB, Stats SA, Thomson Reuters, Absa Research*

Figure 34: Assumptions are key to the outcomes of any forecasting effort

Variable	Absa assumptions (January)	SARB assumptions (January 2020 MPC meeting	General comments and risks to our assumptions
Key Global Economic Assumptions			
Global growth	We used the IMF October 2019 forecast for our global growth assumption i.e., G7 GDP growth of 1.5% for 2020 and 1.4% for 2021 and China GDP growth of 5.8% and 5.9% for 2020 and 2021, respectively.	Growth of SA's major trading partners is projected to be at 2.7% in 2020 and 3.1% in 2021.	Absa's and SARB's global assumptions for model inputs are not strictly comparable. However, both sets of forecasts note that growth prospects in SA's major trading partners have weakened with ongoing downside risks.
Brent crude	Using Bloomberg consensus forecasts as a base, we assume Brent to average USD60/bbl in 2020 and USD63/bbl in 2021.	Brent to average USD66/bbl in both 2020 and 2021.	Absa's crude price assumption is lower than that in our last forecast, in line with consensus. However, geopolitics is always a risk, with the current spot price sitting about 16% higher than the Absa assumption for 2020.
Non-oil commodity prices	We use Bloomberg consensus forecasts for 2020 and 2021 as a base: Gold in USD/oz at 1,506 and 1,444; Platinum in USD/oz at 898 and 940; Coal USD/mt at 64 and 65; Iron ore in USD/mt at 85 and 84.	The SARB does not reveal any specific commodity price assumptions. Instead, it assumes international commodity prices to rise by 2.0% in 2020 and pick up by 2.1% in 2021.	Absa's and SARB's commodity price assumptions are not strictly comparable. The Bloomberg consensus, which guides our baseline, is for moderately higher gold and platinum prices, but of course palladium and rhodium have rocketed sharply higher. Iron ore prices, which have shot up in early 2019 due to Brazil supply concerns, are expected to ease slightly.
Key Domestic Economy assumptions			
Food prices	We forecast food price inflation to average 4.1% in 2020 and rise to 4.5% in 2021 and 2022.	The SARB typically does not reveal its forecast profile for food price inflation, but noted that it projects an average of 4.7% for 2020, down from a previous forecast of 5.8%.	Higher crop prices are already exerting upward pressure in crop-related parts of the CPI basket, while meat prices are rising gradually. These two factors are likely to drive food price inflation higher in the near term.
Fuel taxes and levies	We assume a 10c/l rise in distribution margins each December and a 30c/l increase fuel levies in April 2020.	Taxes and levies on fuel are expected to rise by 6.1% and 5.6% in 2020 and 2021, respectively.	Among other measures, the National Treasury is likely to announce higher-than-inflation increases in the general fuel levy in the February 2020 budget as a way to lift tax revenues.
Electricity prices	We have assumed average electricity tariff increases of 10.0% for 2020 and 6.6% for 2021.	The SARB expects average electricity increases of 10.4% in 2020 and 7.4% in 2021.	Eskom's court reviews of recent NERSA decisions are an upside risk to electricity tariffs.
Growth in government consumption	We forecast real government consumption (G) growth of 0.4% in 2020 and 0.2% 2021.	The SARB no longer publishes its assumption for G.	The need to stabilise the growth of government indebtedness and the slow pace of economic growth will limit the growth of government consumption.
Potential growth	1.1% in 2020 and 1.2% in 2021.	1.1% in 2020 and 1.2% in 2021.	Assumptions about potential GDP growth are tricky as they cannot be directly observed, but instead estimated by using statistical techniques on recent GDP trends. We and the SARB expect the negative output gap to persist over the forecast horizon.
Neutral real interest rate	Absa's model makes no explicit assumption about the neutral real interest rate.	The neutral real interest rate is estimated to be 2.4% in each of 2020 and 2021.	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 real rates everywhere.
Exchange rate	In Absa's macro model, our exchange rate serves as an exogenous input. Our baseline forecast assumes a NEER depreciation of 2.7% and 8.1% in 2020 and 2021.	The SARB's QPM model endogenously determines the exchange rate path, forecasting a NEER depreciation of 1.6% in 2020 and 2.1% in 2021.	The exchange rate is one of the most key variables in any forecast, regardless of whether it is set as an exogenous assumption or endogenously determined, as with the SARB's new QPM. The volatility of the rand and the uncertainty about its path over the forecast horizon pose risk to the model's forecast.
Interest rates	On balance, we expect the SARB to leave the repo unchanged at 6.25% for the foreseeable future.	The SARB's QPM the run done before the January meeting embedded two 25bp rate cuts over the forecast horizon.	The FRA market is fully discounting a 25bp repo rate cut by Q2 20 at the time of writing. With a divided MPC, calling its decisions is difficult.

Source: SARB, Refinitiv, Bloomberg, Absa Research

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