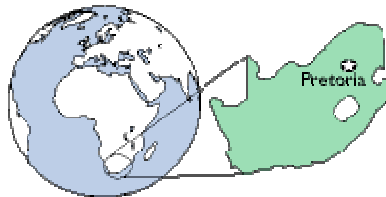


COUNTRY REVIEW

South Africa



2 December 2009

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EULER HERMES COUNTRY RISK GRADE: BB

**Country Risk Grades are on a scale of AA, A, BB, B, C, D
where AA is the lowest and D the highest risk.**

Strengths

- Geographic and economic size engender regional dominance
- No external threats to sovereignty
- ANC government has a strong mandate; political stability to continue
- Political, judicial and security systems entrenched and aligned with Western 'norms'
- Economic management is good, with monetary and fiscal policy agencies highly regarded
- Exemplary exodus from foreign debt problems of the mid-1980s
- Business environment generally favourable, with practices familiar to European practitioners
- Relations with IFIs are good

Weaknesses

- Open economy leads to occasional currency and external account pressures
- Long-term problems require policy and action, including unemployment, rural poverty and HIV/AIDS (an estimated 5.7mn are infected out of a total population of around 50mn)
- Lingering concerns in relation to LT policy stance now that Jacob Zuma is head of state
- Current account and fiscal deficits require careful management
- Danger of policy ossification in regard to privatisation and labour relations
- Inward investment weighted towards portfolio flows rather than FDI
- Power generation has not increased sufficiently to meet growing demand and there have been periods of rationing of supply for homes and industry
- Relatively weak liquidity levels
- Labour market inflexibility

Key Risks

- **The rand is an openly traded currency and is susceptible to volatility. An external event causing weakness in emerging market currencies as a class could lead to a run on the rand, with associated policy concerns and deterioration in economic data**

Country Risk Assessment

Ratings	South Africa		Median Grade BB	Tunisia	Peers	
	Latest	Previous			Saudi Arabia	India
Systemic Political Risk:	P2-	P2-	P2+	P2-	P2-	P2-
Systemic Economic Risk:	E3	E3	E3	E3	E3	E4
ME rating:	ME3	ME3	ME3	ME3	ME3	ME4
<i>Structure</i>	2.3	1.6	3.2	3.3	5.0	4.0
<i>Policy</i>	4.2	4.2	4.3	3.5	5.2	5.2
<i>Solvency</i>	1.0	1.0	1.6	3.2	1.0	1.9
<i>External Liquidity</i>	5.8	5.8	3.3	2.8	3.3	3.6
SBE rating:	SBE3	SBE3	SBE2	SBE3	SBE2	SBE4
COUNTRY GRADE:	BB	BB	BB	BB	BB	B

Nomenclature:

Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).

Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).

ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).

The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).

SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).

Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Country Risk Unit

ECONOMIC STRUCTURE

Country Profile

Capital city:	Pretoria
Population:	49.67 mn (2008)
GDP:	USD 276446 mn (2008)
Currency:	Rand (ZAR)
Form of state:	Federal Republic
Head of government:	President Jacob Zuma
Next elections:	Presidential and legislative 2014

Major Industries (% of GDP at market prices, 2008)		Global Assumptions	2009f	2010f
Agriculture	3.0%	Real GDP grth (% yr/yr) *	-3.9	0.9
Industry	34.0%	Inflation (% , av) *	-0.1	1.3
Services	63.0%	Dated Brent (USD/b)	62.0	80.0
		* major economies		

Main Exports (% of total, 2008)		Main Imports (% of total, 2008)	
Platinum	14.5%	Petrochemicals	13.0%
Gold	7.5%	Vehicle parts	7.0%
Coal	5.0%	Vehicles	5.0%
Vehicles & parts	4.0%	Fuels	5.0%
Lead Export Markets (% of total exports, 2007)		Lead Import Markets (% of total imports, 2007)	
US	11.9%	Germany	10.9%
Japan	11.1%	China	10.0%
Germany	8.0%	Spain	8.2%
UK	7.7%	US	7.2%

Basic indicators

Selected economic indicators	2006	2007	2008	2009f	2010f
Nominal GDP (USD mn)	257,730	283,743	276,446	287,390	293,333
Population (mn)	48.64	49.17	49.67	50.19	50.72
GDP per capita (USD)	5,299	5,771	5,566	5,726	5,783
Real GDP growth (% yr/yr)	5.4	5.0	3.0	-1.6	3.0
Inflation (% , average)	3.2	6.1	9.9	7.0	6.0
Fiscal balance (% of GDP)	0.6	0.2	-1.1	-6.3	-5.1
Current account balance (% of GDP)	-6.3	-7.3	-7.6	-5.2	-4.1
External debt/GDP (%)	13.8	15.3	16.5	14.9	15.3
External debt/Exports of goods & services (%)	43.1	44.9	43.6	49.3	46.9
Debt-service ratio (%)	6.6	5.9	6.7	7.1	6.8
Foreign exchange reserves (USD mn)	22,720	29,234	30,238	32,250	37,000
Import cover (months)	2.8	3.0	2.9	3.9	4.0
Exchange rate assumption, ZAR:USD (av)	6.77	7.05	8.26	8.53	9.00
f: CRU central forecast					

Sources: Central Bank, IMF, World Bank, Euler Hermes Country Risk Unit

Political Stability

The African National Congress (**ANC**) has been the dominant political force since the successful transition to multi-racial politics in 1994 and it was **re-elected** in 1999, 2004 and **again in April 2009**, with large majorities in parliament and in the provincial governments. It retains a formal alliance with the Congress of South African Trade Unions (Cosatu) and the South African Communist Party (SACP). Periodically, there are rumours of the 'umbrella' organisation that is labelled the ANC breaking up, with Cosatu and SACP following independent paths. However, these organisations would have much to lose from distancing themselves from the seat of power. Moreover, such a division would be largely positive. The **lack of effective party opposition** could be a source of concern in the future, but in the interim it provides political stability and aids policy formulation and ratification. Given the ANC's commitment to broad consultation and to orthodox economic policies, **concentration of power does not pose a major risk to business, at this stage**. At the end of 2007, the ANC held elections for the party leadership. The then incumbent state president, Thabo Mbeki, lost that vote to Jacob Zuma, who had been sacked as national deputy president because of allegations of financial malpractice while in office. Following the April 2009 general elections, the ANC duly appointed Zuma as head of state and he was sworn in on 9 May 2009. Despite Zuma's appeal to the left-wing of the party, in general, and to the ANC Youth, in particular, there has not been a noticeable change in policy direction and concerns that elements of Marxism would be adopted have been proved to be unfounded. Nevertheless, Zuma, while remaining pragmatic, will have to provide some electoral dividend to the left-wing constituency.

Despite its popularity, the ANC faces a number of major policy challenges. Although **commitment to market economics underpins overall stability**, poverty remains a major problem, inequality is widespread, unemployment is officially around 24% and over 11% of the population is infected with HIV/AIDS. The Medium-Term Expenditure Framework (MTEF) reflects the government's desire to make faster progress on these issues, which affect core ANC supporters disproportionately. Its main proposals include increased **investment in education, health and transport infrastructure, as well as accelerated black empowerment initiatives**. Significantly, it is the years of fiscal conservatism following the political transition that are now allowing the current expansionary focus to expenditure on infrastructure and social improvement.

The judicial system is good by international standards and almost exceptional in Africa, providing positive support to the business environment. Despite South Africa's reputation for violent crime, the **rule of law is well established** and, unlike in neighbouring Zimbabwe, has not been undermined following political transition. In regional terms, South Africa stands out in terms of its size, political stability and pillars of political and civic society. There are reports of corruption but it is not as pervasive and entrenched as elsewhere in Africa. Moreover, South Africa has been successful in easing ethnic divisions in the wake of apartheid—most notably through improved security in Kwa-Zulu Natal and in the pioneering work of Archbishop Desmond Tutu and the Truth and Reconciliation Commission. As a result, political violence is unlikely to impact negatively on business. Nevertheless, **non-political and often violent 'social' crime remains a concern** for businesses and investors.

International relations are generally very good, although negative perceptions of regional risk emanating from the ongoing crisis in Zimbabwe remain and are compounded by the apparent failure of successive presidents (Mbeki and now Zuma) in limiting the worst excesses of the Mugabe regime. South Africa adopts a high profile in continental (and increasingly international, particularly through the G20) affairs. Governments have shown commitment to the spread of good governance and economic co-operation through such agencies as the African Union (AU), New Partnership for Africa's Development (Nepad) plan and UN-sponsored initiatives. Good relations with IFIs signify that timely financial assistance would be forthcoming in the event of a deep and sustained crisis, although a formal IMF facility is currently unnecessary.

Economic Stability

South Africa is categorised as an upper-middle income economy by the World Bank, and per capita GDP is currently estimated at over USD5,700. However, society is polarised, with highly developed—and relatively wealthy—urban centres but many townships and rural areas suffering high levels of poverty and unemployment. Some improvements have been made and a black middle-class is being created. The **economy is relatively open, with exports and imports both equivalent to around 30% of GDP**. Despite a particularly strong price surge in commodities (particularly gold and platinum) in the period 2007 to the present date, South Africa's **dependence on the gold industry has been reduced significantly, with the mining sector as a whole contributing less than 10% of GDP**.

(compared with manufacturing's 14.4% share) and both platinum group metals (35% of mineral sales) and coal (20%) contributing more to mining output than gold (17%). The country is the **world's largest producer of platinum group metals, chrome, manganese and vanadium, as well as a leading exporter of gold, coal and diamonds**. Long-term growth of real GDP per head has been lacklustre, but has improved (averaging around 2.7% annually over the last decade) since the ending of sanctions, political transition and full re-acceptance of South Africa into the global economy.

A marked shift has emerged in economic data. Until 2004 annual real GDP growth was viewed as effectively capped at around 3%. This largely reflected a legacy of the apartheid era of structural impedimenta, principally the high financing requirements if the current account was allowed to register deficits. Relatively relaxed monetary and fiscal policies enabled **annual GDP growth to register an average 5% between 2004 and 2008**. As well as strong domestic demand and increased pace of investment plans, the export sector was boosted by sustained global commodity requirements in that period. We forecast that, given South Africa's openness to external factors (partly because of its relatively sophisticated economy compared to the rest of the continent); **GDP will contract by around 1.6% this year**. The global recovery in 2010 is forecast to be muted and, despite tentative signs of renewed growth in the South African economy—Q3 2009 GDP expanded by 0.9% qtr/qtr after three consecutive quarters of contraction—**overall economic growth is forecast at 3% in 2010**, thereby remaining below the recent 5% trend. The 2010 Football World Cup will spur some additional growth next year, but a strong rand, de-leveraging by households and power supply restraints as a result of insufficient new investment to upgrade and extend the electricity grid will restrict that rate of growth.

A feature of economic policy in the post-transition years had been tight fiscal control and refusal to raise expenditure purely in terms of a 'post-apartheid dividend'. The revenue collection service has been overhauled and tax receipts and other dues increased substantially. The consolidated **government deficit** remained below 3% of GDP (an internationally-accepted safe benchmark) for several years and **in 2006 and 2007 it was turned into a small surplus**. Recent budgets (and rolling revisions to the Medium Term Budget Policy Statement, MTBPS) have focused on expenditure allocations to improve infrastructure, extend service delivery and assist schemes to alleviate poverty. However, while fiscal orthodoxy is likely to continue, a stimulus to try and generate growth (as in most economies) combined with revenue shortfalls as activity slowed, resulted in fiscal **deficits returning in 2008 (-1.1% of GDP) and deteriorating this year (projected at -6.3% of GDP)**. While budget deficits of 3-6% of GDP will not prove difficult to finance in the short term, given good access to both local and international capital markets, the fiscal position needs to be monitored closely going forward. The continuing presence in an economic role of former finance minister Trevor Manuel provides some evidence that sound policies will prevail.

South Africa was one of the first emerging markets to adopt inflation targeting, which is the responsibility of SARB, the central bank. Monetary policy was effective through to 2006, with consumer price (CPI) increases averaging 1.4% and 3.5% in 2004 and 2005, respectively, compared with a **target range for CPI of 3-6%**. However, a period of sustained high oil prices, with both direct (through fuel costs) and indirect (through inter-connectivity in the economy) upward pressures, resulted in inflationary stresses and the target range **was breached throughout the period 2007-09**. The rate of average price increases (CPI) is now slowing, but some upward pressures will resurface in 2010 as the economic recovery deepens, thereby **limiting average inflation to the top end of its target range next year, rather than falling within it**. As ever, rand volatility cannot be discounted, with resulting pressures to adjust monetary policy.

A more marked structural change since the political transition has occurred in the external sector. During the period of sanctions, large current account surpluses were engineered as a way to counter the impact of large capital outflows. With a new political dispensation and trade liberalisation, South Africa in 1995 recorded its first current account deficit for ten years. In 2005, the **current account deficit** was equivalent to 4% of GDP but it increased to an **average 6-8% in 2006-08**, reflecting strong consumer demand for imports and the higher cost of inflows of oil in that period. Nevertheless, FX reserves were accumulated in the period 2004-08, indicating good capital inflows. FX reserves totalled around USD6bn at the time of the closure of the central bank's net open forward position in May 2003, but ended 2008 at over USD30bn and are likely to be around USD32bn at end-2009. **Import cover is now around four months**. Future financing gaps should be monitored for signs of stress, but are likely to be met relatively comfortably, with FDI inflows now supplementing equity portfolio investments. Significantly, all three major rating agencies classify South Africa as investment status. Despite reserves accumulation, some external liquidity indicators remain weak, particularly

M2/FX. Nevertheless, good solvency ratios—external debt is around 15% of GDP and 45-50% of export earnings—are a mitigating factor. The debt service ratio is a comfortable 6-8%.

Structural Business Environment

The **business environment is sound** and generally above average for the countries we assess. However, there are some structural impediments to strong, stable, sustainable growth, including labour market inflexibility and rural poverty. The Heritage Foundation's 2009 Index of Economic Freedom (IEF) categorises South Africa as 'mostly free' and assigns it a ranking of 61 out of 179 countries assessed, below Uganda, France and Romania but above Peru, Malaysia and Saudi Arabia. The IEF notes that South Africa scores above the world average in eight out of ten freedom categories and the financial system is one of the most advanced in Africa and that the legal environment is relatively free from political interference and the threat of expropriation. According to the latest World Bank Doing Business survey (2010), enforcing contracts involves less procedures and time than the regional average and the cost of doing so is much lower. Insolvency proceedings can be completed more rapidly and less expensively than on average for the region and the recovery rate is almost double the regional average, although recourse to the courts is likely to be involved. Overall, South Africa is **ranked 34 out of 183 countries assessed by the World Bank in terms of the ease of doing business**. In Transparency International's Corruption Perceptions Index 2009, South Africa ranks 55 out of 180 countries assessed, below Poland, Czech Republic and Lithuania but above Latvia, Malaysia and Namibia.

The banking sector—adapting successfully to Basel II—is also relatively sophisticated and sound. Although only five large banks account for over 80% of sector provision, the industry is well regulated and supervised by the central bank, and has shown resilience in the face of periodic currency volatility and during the recent global financial crisis. However, under the Financial Services Charter, banks are directed to have 25% black ownership by 2010 and employ higher numbers of disadvantaged individuals in management. Outside the formal sector, there are many micro-finance institutions and credit suppliers to the traditionally disadvantaged members of society.

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Charts

