The Economy in 2020

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Introduction

The global economy has been hit hard by the trade war waged primarily between the US and China. And while some signs might have emerged at the end of 2019 that trade tensions have eased, the process of economic recovery is not as simple as turning off the trade protectionism switch.

The dislocation of global trade patterns by protectionism has been a crucial part of the global economic slowdown. There might be some hope that the late-2019 phase-one trade agreement between the US and China will usher in a trade environment that's more conducive to growth in 2020.

Much depends on whether incremental improvements in US-China trade relations can lift business confidence and whether the policy easing that central banks and governments have put in place to counteract the trade tensions can bear fruit. We are sceptical on both fronts. We doubt any further US/China trade deals will be agreed in 2020, partly because the US election will take up more political time for the Trump administration and partly because the phase-one deal covers only the low-hanging fruit.

2020; the year of the rat. Like China, we are sceptical of economic growth improving in 2020 for developed countries, and risk assets that are supported by abundant liquidity may tumble due to high asset-price valuations, rising global debt, or whatever the shocks may be.

Economic growth in the world's second-largest economy is likely to drop below 6% in 2020, which would be the first time since 1990, down from 6.1% in 2019 and 6.6% in 2018, marking a third straight annual slowdown. And, of course, GDP growth could fall lower in a worst-case scenario: if trade talks break down again; the ongoing liquidity challenges facing smaller banks fail to be ring-fenced; or a large enough share of corporates struggle to meet their debt obligations.

We expect elevated global financial markets and growth in developed economies to boost economic growth in Africa. A point worth noting is that capital flows to Africa will most likely support economic growth in the medium term. Of course, much of this is used for investment spending. African governments for example, can take advantage of buoyant financial markets to issue Eurobonds that are used for infrastructural development.

In South Africa, the year ahead may be a defining one politically. A relatively rare election-free calendar may allow a more assertive stance from government in resolving some of the country's pressing structural challenges. Yet, in providing such steer, President Cyril Ramaphosa will need to carefully balance competing, and often conflicting, interests from the various stakeholders – in the ANC, government, business, civil society, and the labour movement, amongst others – that he has since his election as party leader in December 2017 sought so routinely to placate.

It is likely that the president will continue to err on the side of caution in this regard, offering incremental – though still meaningful – progress on matters related to economic policy and SOE restructuring. Critical trade-offs will likely become more apparent in 2020: though government is unwilling to consider meaningful job cuts at, or direct privatisation of, Eskom, it is nonetheless pushing forward with the utility's unbundling and is evidently intent on supporting the deregulation of the energy sector, thus enabling far stronger private sector participation in electricity generation in order to alleviate the damaging effects of load-shedding on growth and confidence.

We pencil in a modest growth rebound in South Africa's economic growth in 2020, to around 0.8% from an estimated 0.3% in 2019. This is supported by the elevated terms of trade and financially robust high-income consumers, though it will critically depend on the extent of electricity load shedding. The fiscal and electricity crises clearly mean that government should not delay decisive policy reforms. Thus far, government's growth-supportive adjustments have comprised focused, uncontentious policy steps, which haven't been adequate to lift confidence from its lowest levels in decades. This includes both industry- and company-specific interventions to navigate binding government bureaucracy and red tape; more general interventions to make it easier to do business, such as shorter timelines to issue select government licences and the one-stop business registration website now being piloted; and specific programmes, such as the e-visa regime currently being piloted. In addition, the Infrastructure Fund is one of the first concrete programmes aimed at increasing private sector participation in areas previously monopolised by the state and state-owned enterprises.

We remain optimistic about government's ability to meet the stated presidential target of improving SA's ranking in the World Bank's global Ease of Doing Business Survey to 50 from 85 currently. The new one-stop online business registration system alone can boost SA's ranking by an estimated eight places at least.

The marginal growth improvement that we foresee in 2020 to a large extent reflects an assumption that the weakness or contraction in select sectors will ease, rather than any meaningful new growth impetus. Clearly, a key growth determinant in 2020 will be Eskom – including both the impact of the electricity shortfall on output and firms' willingness to expand capacity and the impact on the fiscus and, in turn, confidence about the fiscal and growth prognoses.

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G10 outlook for 2020

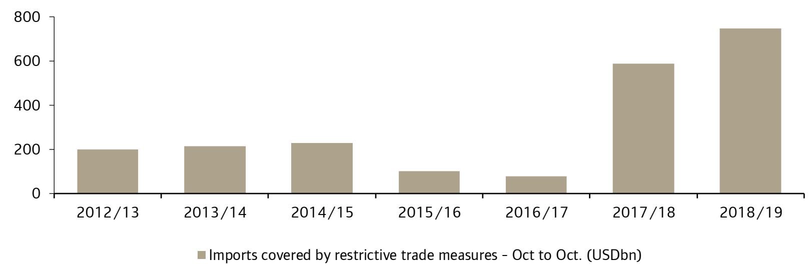
Caution is advised

The global economy has been hit hard by the trade war between the US and China. Trade tensions have eased but the process of economic recovery is not as simple as turning off the trade protectionism switch.

Slow healing

For last year, we predicted that global growth would be weaker than most estimates; probably somewhere in a 3%-3.5% range. It seems as if the outturn will be at the very bottom end of this range, and we doubt that 2020 will be much better. A slide to below 2.5% would be seen by many as a recession, albeit a fairly modest one. While we err to the view that recession can be avoided, we'd expect it to be a close shave. The dislocation of global trade patterns by protectionism has been a crucial part of the global economic slowdown. There might be some hopes that the late-2019 Phase One trade agreement between the US and China will usher in a trade environment that's more conducive to growth in 2020. However, we have to remember that while this accord spared China the imminent imposition of tariffs on around USD160bn of goods exports to the US, the world has still seen some USD747bn of import-restrictive trade measures in the year to October 2019; an increase of almost tenfold from the year prior to President Trump's election win (Figure 1).

Figure 1: Protectionism surges

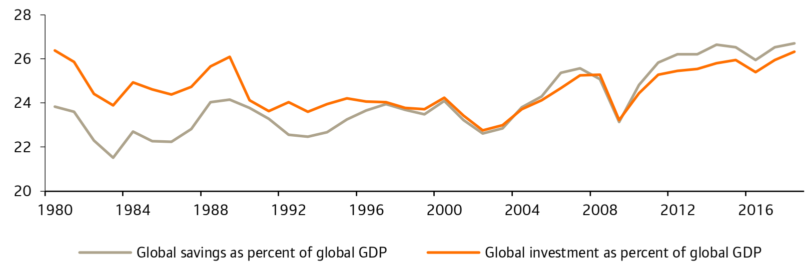


Source: World Trade Organisation

Much depends on whether incremental improvements in US/China trade relations can lift business confidence and whether the policy easing that central banks and governments have put in place to counteract the trade tensions can bear fruit. We are sceptical about both. We doubt any further US/China trade deals will be agreed in 2020, partly because the US election will take up more political time for the Trump administration and partly because the Phase One deal covers only the low-hanging fruit. Future trade deals will be harder to achieve and continued tensions with others, such as the EU over autos and aircrafts, could still leave the US administration on a collision course with many of the worlds large trade-surplus countries. There are some signs that the trade-inspired damage to global manufacturing might have come to an end. Purchasing manager surveys, for instance, have stabilised. However, we have to remember that the manufacturing sector is only around 15% of global value added and the much bigger services sector is showing few signs of improvement. Generally speaking, employment levels in developed countries remain very high and wage growth is improving. But these trends mask the real problem, which is poor productivity. Real economic prosperity can only come through rising productivity. The strength in employment and improving wages merely reflect the fact that investment has been poor and, with it, productivity growth. This weakness in global investment not only hurts productivity, it has also led to a global savings surplus (Figure 2). Excess savings relative to investment not only accounts for the very low level of global bond yields and policy rates; it also leads to strong inflows into 'riskier' financial investments, such as equities.

This helps explain why **global stock markets have generally remained quite elevated even as the global economy has stalled**.

Figure 2: Excess savings



Source: IMF

More help needed

Central banks and some governments have put policy in place to counteract the deterioration in economic fortunes. Lower policy rates could aid investment but a rebound in investment is more an issue dictated by global trade-related confidence, not borrowing costs. We believe that the bias for global monetary policy will still be towards further easing in 2020 even if, for many, **the scope to ease policy is limited**. Those with very low policy rates, such as the ECB and BoJ fear that the so-called 'reversal rate' might be close at hand. That's the point where rate cuts are a net drain on the economy, primarily through their adverse impact on commercial banks. Hence, these central banks will probably err towards asset purchases and away from rate cuts. We could also find that some central banks that have not undertaken quantitative easing before start to do so, such as the Reserve Bank of Australia. The Federal Reserve still has room to ease policy after its three "insurance" rate cuts of 2019. We suspect that more insurance will be needed this year, with at least one more cut anticipated.

While many central banks will be trying to scrape out the last dregs of monetary easing, **the pressure on fiscal policymakers to act in tandem to ease policy will only grow**. The US administration has already shown that fiscal easing can shore up growth without the cost of higher inflation and higher yields and it seems that some other governments around the world need to follow suit. Some, such as the UK and Japanese governments, appear to have heeded the message but fiscal expansion in the euro zone, and Germany, in particular, appears insufficient. Given the euro zone debt crisis between 2010 and 2012 we might understand some of this reticence. But today we are talking about budget expansion in countries with large current account surpluses (Germany), not large budget deficits in countries with weak trade positions, as we saw back in 2010/12. The combination of large budget deficits and large trade deficits saw yields in countries such as Greece soar during the 2010/12 crisis. Budget stimulation by Germany and other strong-trade countries today is not going to have the same cost in terms of much higher bond yields. The ECB is certainly putting pressure on the German coalition government to ease fiscal policy and, within the coalition the junior SPD partner is putting the same pressure on the dominant CDU partner. We feel that the fiscal response of Germany, and many other euro zone and non-eurozone countries in 2020 could hold the key to economic recovery just as an easing of trade tensions seems to be a prerequisite for stronger growth.

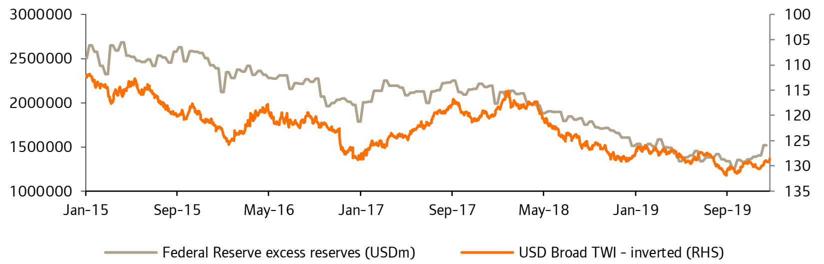
The political dimension

The politics of US/China trade negotiations and the politics of Brexit were the two driving forces for 2019. In 2020 Brexit will remain a hot topic as the UK and the EU try to negotiate a trade deal in what seems an impossibly short amount of time (the deadline is 31 December 2020). Political factors in the US will shift from external trade tensions to internal election uncertainties. As this shift occurs, the Trump administration could dial down some of the trade tensions with other countries for fear of alienating many core Republican voters, such as those from farming communities. But equally, a desire to look tough on trade could see the administration go after different countries and different sectors, such as European car manufacturers. Whatever happens ahead of the 3 November election, we don't doubt that the president will pull out all the stops to keep the economy and the stock market strong, even if this means heaping even more pressure on the Fed to cut rates further. The outcome of the election is a tough call, not least because the identity of Trump's Democratic opponent is not yet known. Should more progressive/left-leaning candidates such as Bernie Sanders or Elizabeth Warren win the Democratic nomination, the stark contrast with Trump could unnerve the market in the same sort of way that the UK election did in late 2019. But provided the economy holds up and Trump's alleged indiscretions, such as those that resulted in impeachment proceedings, don't undermine support, **he may prove a hard president to unseat**, just as most first-term presidents have been in the recent past.

Dollar in decline

President Trump might have been able to achieve a number of things, such as a phase-one trade deal with China, but his complaint that the dollar is significantly overvalued has fallen on deaf ears. The dollar ended 2019 just about where it started in broad trade-weighted terms. Provided 2020 sees some easing of trade-related tensions and the Fed continues to re-build its balance sheet, the dollar seems more likely to give some ground, albeit not at the sort of pace that might appease President Trump. The re-building of the Fed's balance sheet could prove a key factor in weakening the dollar. The history of the past few years suggests that the provision of dollar liquidity, however it has been measured, is a key determinant of the dollar's value (Figure 3).

Figure 3: Fed's balance-sheet rebuilding to weigh on the dollar



Source: Federal Reserve

Some other central banks have also called a halt to the decline in their balance sheet. The most notable of these has been the ECB which re-started quantitative easing last year. In theory this could prevent the Fed's easing from lowering the dollar against the euro. However, evidence tends to suggest that, because the dollar has such a dominant role in the provision of global liquidity, it is the action of the Fed that is key, not that of other central banks. Hence, unless the US economy rebounds strongly in 2020 and the Fed starts to tighten again (which we doubt) the dollar seems likely to undergo a modest decline which we'd suggest will be in the 5%-10% range against other developed currencies. For euro/dollar, this implies a level just below 1.20 at the end of 2020.

Brexit has rendered the pound as one of the more volatile currencies in recent years and it could maintain this dubious accolade in 2020 thanks to continued Brexit negotiations and the continued existence of a possible cliff-edge exit from the EU on 31 December 2020 if no trade deal can be agreed between the UK and EU. But, while **the risk of a sterling collapse still exists**, we doubt that things will turn out this way. Trade discussions may have to be extended beyond the deadline, but this should not stop the **pound rising**, very possibly towards 1.45 against the dollar and 0.80 against the euro during the course of the year.

Risk return

In theory, at least 2020 could be set to be a good year for risk assets. From a carry-trade perspective, many funding currencies such as the euro, yen, Swiss franc and even the US dollar still have very low money market rates and volatility amongst the major currencies is some of the lowest we have seen. Figure 4 shows what we call a Global Hazard Index (GHI) which combines implied FX volatility across major currencies to provide a guide to currency risk. It is currently the lowest it has been since the euro came into being in 1999.

Figure 4: Low FX volatility

Source: Reuters datastream

High FX volatility is the enemy of the carry trade given that surges in volatility are usually associated with a rapid strengthening of the funding currency. In contrast, low volatility – and low funding rates – work to the benefit of carry trades. We could add to this hopes that the global economy is turning the corner as trade fears dissipate, that the dollar will slide, and that many risk assets, such as emerging market stocks, have underperformed developed markets and hence appear relatively cheap. But, of course, there are also counter-arguments. For a start, the global economy has enjoyed a long expansion, especially the US, that might be looking both long in the tooth and responsible for a rally in risk assets, such as stocks, that leaves many developed markets overbought and in need of a decent correction. Political factors could still cause havoc in major nations, especially Brexit and the US election. Inflation could make an, unwelcome, return and push central banks back towards tighter monetary policy again. While we could add more reasons for caution, **we think that the odds slightly favour some degree of outperformance from riskier assets**. As we mentioned at the start, global growth may still underwhelm in 2020 but the compensation should come from the persistence – and extension – of easier monetary policy and possibly easier fiscal policy as well. **Returns in risk assets** might not live up to the stellar performance we saw from most assets last year, but **we do anticipate gains**, not losses, for 2020.

Steven Barrow#

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China's outlook, and the implications for Africa and South Africa specifically

An economic stabilization in China likely to be short-lived; GDP growth likely slipping to a three-decade low; a range of material downside risks still testing the agility of policymakers in Beijing and requiring careful navigation; further breakdown in relations with the US; the Phase One trade deal overcommitting China and detracting from China's other trading partners. All this comes against the backdrop of an ongoing structural slowdown, and the restructuring and rebalancing of China's economy.

Welcome to 2020, the year of the rat. We are sceptical of economic growth improving in 2020 for developed countries, and risk assets that are supported by abundant liquidity may tumble due to high asset-price valuations, rising global debt, or whatever the shocks may be.

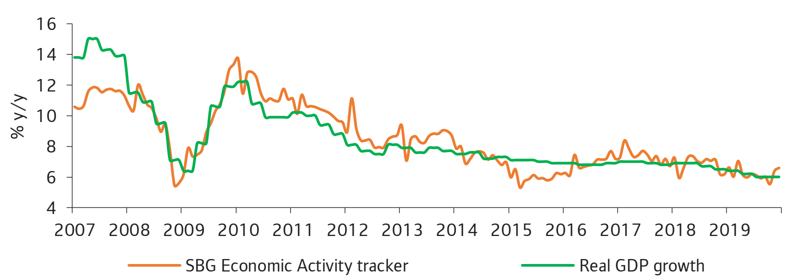
Faced with all this, **African nations have doubled down on regional integration, thereby creating a continental free trade area. This could make African markets more alluring to China** – Africa's most consequential commercial partner but one whose internal adjustments are still yet to be fully metabolized by African countries.

We argue that **the next phase of ties between China and South Africa specifically** must more forcefully and single-mindedly prioritize tactics for further industrialization, job creation, and technology transfer through Chinese investment in manufacturing. To this end, they must shape ties to support South African growth and development, and position South Africa as an engine for intra-Africa trade. **South Africa therefore must make good on its commitment to improving the ease of doing business** in SA as well as its competitiveness.

A China perspective

We aren't convinced the Chinese economy has bottomed out. Granted, the data is much improved since October 2019, with a plethora of monthly macroeconomic data implying that momentum loss seems suspended. Nevertheless, economic growth in the world's second-largest economy is still likely to drop below 6% in 2020, which would be the first time since 1990. That's down from 6.1% in 2019 and 6.6% in 2018, marking a third straight annual slowdown. And, of course, GDP growth could fall lower in a worst-case scenario: think trade talks break down again; the ongoing liquidity challenges facing smaller banks fail to be ring-fenced; a large enough share of corporates struggle to meet their debt obligations; and so on.

Figure 1: Momentum loss ongoing – real GDP growth slowing



Source: CEIC and SBR

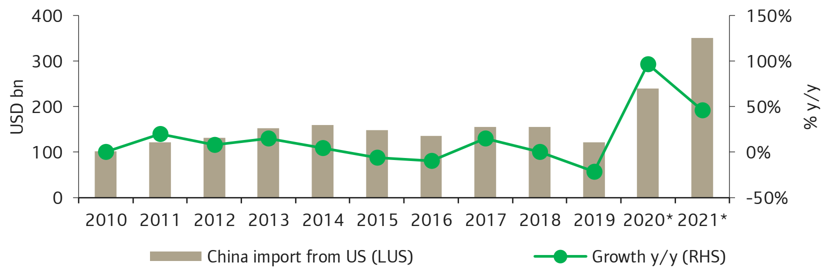
China is amid a profound long-term economic transition that could see growth trend towards 3-4% by 2025. Hence, its performance should be seen in the context of cyclical movements around a decelerating trend: upswings will be shorter than before, and downswings longer.

Nevertheless, the now signed Phase One trade deal will boost global sentiment and financial markets. Whilst China's cyclical slowdown has been driven primarily by domestic forces and policy priorities – specifically tight financial conditions, de-risking the financial sector, weak local government investment and soft domestic demand, the trade war has not helped. Consider that China's exports to the United States tend to grow at a similar rate to China's overall exports. Hence, without a trade war, China's exports may have fallen by 2% y/y in 2019 in dollar terms. That 20 percentage point negative swing, largely owing to trade tensions, probably reduced overall Chinese export growth by about 3-4 percentage points, shaving off 0.8-1.2pp of China's nominal GDP growth in 2019. **The Chinese economy will therefore certainly benefit from removing this particular headwind in 2020.**

Still, **China's near-term trajectory will be determined by Beijing's policy choices**. Even though talk of better use of counter-cyclical tools for macro policy has ramped up in recent months, for now though the goal remains to merely ameliorate some of the most challenged parts of the economy, not reverse the slowing trend. The still relatively weak credit impulse means that if the economy has stabilized, the growth recovery will likely be muted. And, just like last year, the Financial Stability and Development Commission (FSDC), the People's Bank of China (PBoC), and China Banking and Insurance Regulator (CBIRC) have made it clear already that they would press on with the de-risking campaign, defusing financial risks, improve and expand the scope of its macro-prudential regulation, further dismantle the shadow banking industry, prevent real-estate speculation, and work with local governments to reform state-owned enterprises and clear hidden debt. **None of this seems to be broadcasting news of an imminent China economic rebound.**

As for the trade deal, a further breakdown in relations seems more likely rather than a genuine resolution. First, the more difficult issues have yet to be addressed, and China has virtually no room to make any concessions regarding the remaining, far more stubborn and entrenched, issues. Second, **the Phase One deal gives China very little** besides the US pledging to reduce the 15% tariffs on USD120bn worth of Chinese goods to 7.5% and suspend plans for other tariffs. Resentment will no doubt build. Third, China has overcommitted, agreeing to purchase a staggering USD200bn in goods and services from the US by the end of 2021 – an increase of 100% y/y in 2019 and 45% y/y in 2021. If so, third countries from both the developed and developing world would need to be prepared. These targets force China to shift purchases of oil seeds, for example, away from Brazil, Argentina, Ethiopia, Tanzania and others. The same applies to fish and lobster away from Russia and Canada; cars from the EU or Japan; industrial machinery at the expense of the EU, Japan, and Korea; and pharmaceuticals away from Switzerland.

Figure 2: China's import targets from the US in 2020 and 2021

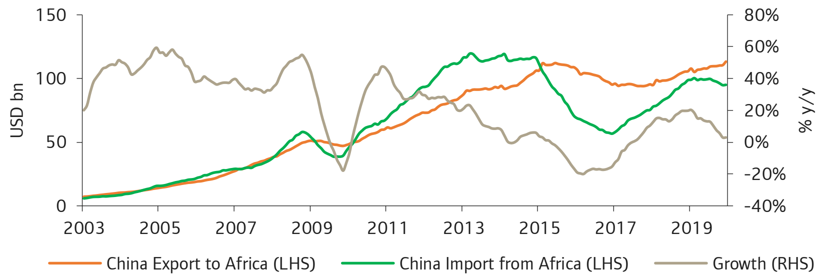


Source: PIIE, CEIC, Standard Bank Research

Implications for Africa

Africa should take heed. China-Africa trade may appear to be an unstoppable multi-billion-dollar juggernaut — but it would be foolish to ring-fence Africa's relations from the current developments underway inside the Mainland. China-Africa trade growth plummeted from 20% y/y in 2018 – the fastest since 2011 – to just 2% y/y in 2019, a bi-directional total of USD208bn. China's connection to Africa has been changing, with the broader China-African relations seeing a more selective and focused engagement from China. China's "new normal" matters: its slowdown, rebalancing, de-risking of the financial system, and emphasis on the Belt and Road initiative, along with the distraction of the trade war, all have **conspired to divert China's attention away from Africa.**

Figure 3: China-Africa bi-directional trade growth (annualised)



Source: China's General Administration of Customs, CEIC, Standard Bank Research

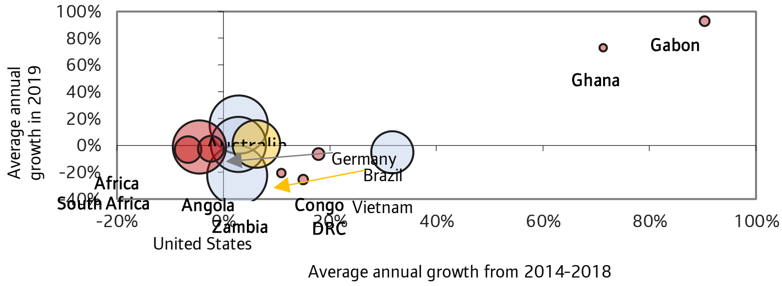
African exports to China contracted 3.7% y/y in 2019, having rebounded 31% y/y in 2018 largely due to lofty commodity prices. Given the rich representation of Africa across the spectrum of global commodities, it is no surprise that Africa is sensitive to changes in China. Drummond & Liu (2013:5) estimated that a one percentage point decrease in China's domestic investment growth is associated with an average 0.6 percentage point decrease in Africa's export growth. The World Bank (2015) estimated that **a one percentage point reduction in China's growth results in a 0.37 percentage point decline in output growth in specifically South Africa.**

China accounts for the largest proportion of global imports of the natural resources Africa exports. But, China's role in global commodity markets is changing now as it undertakes a transition from a growth pattern that is highly intensive in its use of natural resources, driven by investment and the development of heavy industry, to **a more sustainable path that uses these resources less intensively** (Mi et al, 2018:1007 and Roberts et al., 2016:147). China's lower growth rate and changing demand composition are already **affecting commodity prices**, with a particularly strong impact on global mineral markets (Pigato and Tang, 2015:10).

The trade data bears this out: South Africa's exports to China, for example, peaked at USD48bn in 2013 and has averaged USD25bn each year over the past three years (USD26bn in 2019). **Worryingly, South Africa is also falling down the pecking order in China's hierarchy of trade partners**: in 2013 South Africa was China's 12th largest source of goods and has since fallen outside the top 20 – and its share of China's imports has halved. Meanwhile, several other emerging markets, like Brazil, Malaysia, Thailand and Vietnam have seen sales to China increase rapidly over the past decade. **Worse still, the next two years will be rough, muddied by trade tensions between the US and China, which may, to some extent catch certain African nations in the crosshairs**. China committed to purchase a staggering USD200bn in goods and services from the US by the end of 2021 – an increase of 100% y/y in 2019 and 45% y/y in 2021. If these are to be met, it will cannibalise China's purchases from elsewhere, like oil seeds away from Brazil, Argentina, Ethiopia, Tanzania and others.

Over the next five years, **we expect Chinese import growth from Africa to expand just moderately**, to around USD150bn by 2025. China's largest impact on global commodity markets will come from supply-side structural reform and environment policy tilt rather than from ever-growing demand for raw materials.

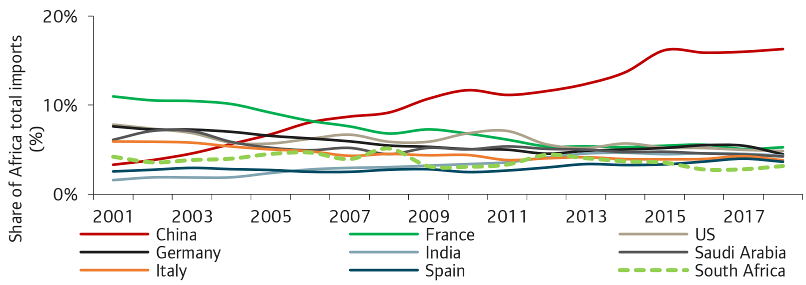
Figure 4: South Africa/Africa exports size and growth to China relative to peers



Source: MOFCOM

Meanwhile, Chinese exporters continue to diversify towards emerging markets, and tapping into Africa's fast-growing consumer markets is likely to continue unabated. Africa is now the destination for 4.5% of China's total exports – double that of a decade ago, and more than Africa's share of global GDP of 2.8% in 2018. Across Africa, Chinese goods have penetrated markets deeply, increasing from 3.7% of Africa's total imports in 2001 to 19.0% in 2019. Around two-thirds of African countries list China as their largest source of goods. In contrast to China's growing penetration, Africa's traditionally large trading partners, such as France, the United Kingdom and the US, have seen their market hare decline. Similarly, **South Africa's share of Africa's total imports peaked in 2003 at 8.0% but has slipped to 4.6% in 2018.** Granted, South Africa is still the largest trading partner of countries such as Namibia, Mozambique, Zambia and Zimbabwe but its foothold is being diminished. **We expect Chinese exporters to tighten their hold on Africa's consumer markets**. Last year China's exports to Africa expanded by 7.2% y/y, from USD105bn in 2018 to USD113bn in 2019. By 2025, exports to Africa could surpass USD200bn, expanding 10% p.a. over the period as Chinese exporters diversify their target markets, with Africa being their focus.

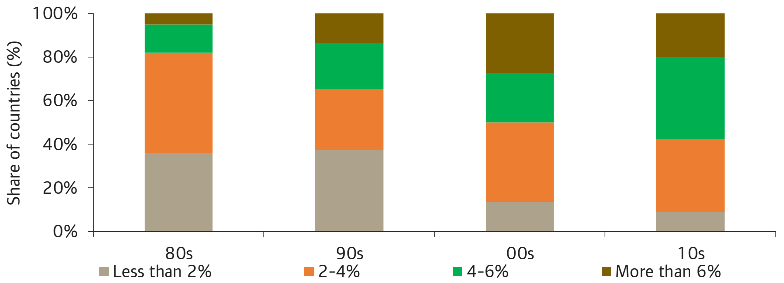
Figure 5: Rising penetration of Chinese exports in Africa



Source: ITC, CEIC, Standard Bank Research

Our view is underpinned by a relatively constructive cyclical and structural outlook for Africa led by relatively robust economic growth in some key economies such as Ethiopia, Ivory Coast, Tanzania, Mozambique and Ghana. In addition, over half of Africa's economies will likely expand by at least 5.0% in the next five years, whereas less than one-third have done so in the past five years. This improved cyclical story weds neatly to the structural forces, like favourable demographics, urbanization and industrialization, and rising incomes and a growing middle class, which remain intact and continue to play out across many African economies. It is well understood in China **that African economies present a host of compelling opportunities for trade and investment.**

Figure 6: Distribution of GDP growth in Africa



Source: IMF

The case for a manufacturing focus

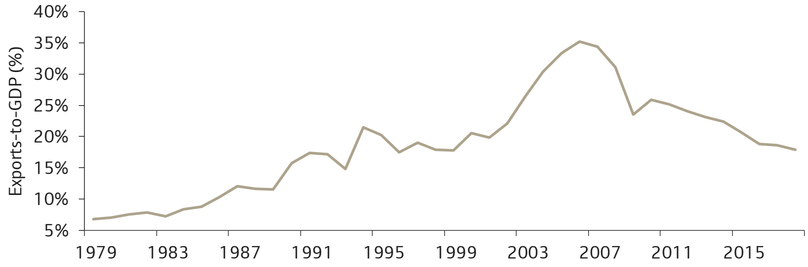
Unlike the rapidly growing Asian economies whose rising incomes have been associated with structural shifts from agriculture to industry, **African countries have tended to bypass manufacturing**, shifting from agriculture to services, with relatively sluggish industrial employment growth (Kumar and Bergtrom, 2013:54). The share of African manufacturing in GDP rose from 6.3% in 1970 to a peak of 15.3% in 1990 and has since significantly declined, to around 10% last year. **Growth without industrialization has meant that Africa's growth has not been sufficiently labour-absorptive** to allow for upward income migration of the population. In addition, African manufacturing is not only small in size, but it is dominated by firms in the informal sector not on the same escalator as modern firms with access to technology, markets, and finance.

The divergent path between Asia and Africa is glaring in Africa's poor intra-regional trade relations. A mere 13.5% of Africa's total trade occurs amongst African nations, which is considerably lower than Asia (58%) – and Latin America for that matter. Herein lies the rub: **the overlap between African demand and supply is negligible**. Instead, China has increased exports to Africa twelvefold since 2001. Worryingly, for the first time, China's overall trade with Africa surpassed total intra-Africa trade in 2018. Intra-Africa trade peaked at USD182bn in 2013 and subsequently fell to a low of USD125bn in 2016. Since then, intra-Africa trade has increased by 9% y/y and 5% y/y in 2017 and 2018 respectively, tallying USD144bn in 2018.

China-Africa ties and partnership must now single-mindedly prioritize tactics for further industrialization, job creation, and technology transfer through Chinese investment in manufacturing industries, led by the private sector, in a manner that supports African growth, development and intra-Africa trade. Attracting greater Chinese engagement and investment in African manufacturing, which includes not only the transfer of capital, but crucially the movement of firm-specific assets such as technology, managerial ability, corporate governance and access to the network connecting markets, must be the overarching objective.

Chinese firms have developed the experience and know-how. China has emerged as the largest manufacturer in the world – known as "the world's factory". The countries own recent history suggests Chinese policymakers are familiar with the nature of the goal. In addition, the Chinese economy is in the process of transformation – expanding more slowly and is less factor – and investment-driven, shifting towards a pattern of growth driven by services and consumption; propelled by innovation and with market forces determining the allocation of resources. Accelerating real wage growth and rising unit labour costs in China from the mid-2000s has raised the possibility of relocation of production and jobs from export-oriented labour-intensive – especially light manufacturing industries to low-income countries. For the time being, the preferred respond to the challenges of rising costs and tighter demand by means of adjustments in existing operations – upgrading technology, controlling costs, expanding markets or product ranges – rather than by establishing production operations in a new location.

Figure 7: Exports as a share of total GFP



Source: General Administration of Customs & SBR

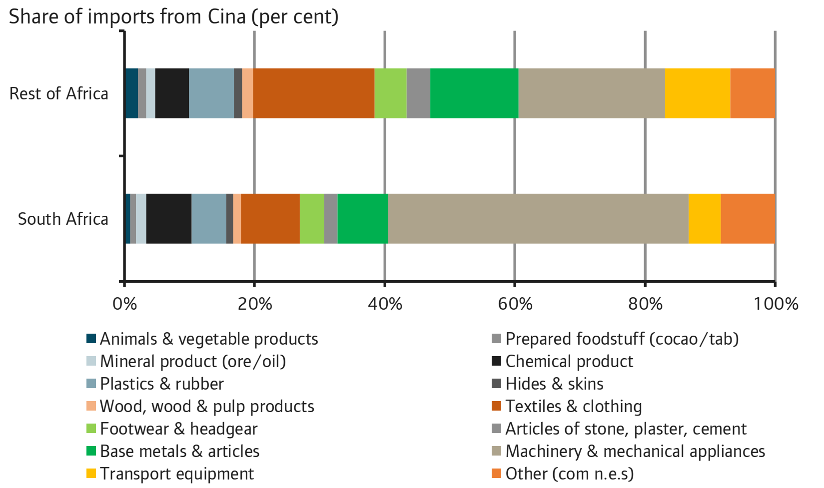
Looking ahead though, as wage rates in China continue to rise, Africa should be exploit emerging opportunities for investment in export-oriented manufacturing (Pigato and Tang, 2015:5). It is a logical progression that outbound investment in manufacturing is most likely to follow Chinese sales, and some of China's fastest growing export markets are in Africa. China's exports to Africa expanded by 10% y/y and 7% y/y in 2018 and 2019, respectively. **This is exactly what South African corporates should be leveraging, thinking of ways to collaborate with Chinese firms in Africa** — especially as industrial restructuring in coastal China forces some labour-intensive firms to relocate to other parts of the developing world, including Africa. Importantly, the Africa Continental Free Trade Area (AfCFTA) fits many criteria to indeed be the catalyst for China-Africa ties.

Potentially, **inside Africa's more open economies will be opportunities in consumer-facing industries** such as retail, telecommunications and banking; infrastructure-related industries; across the agriculture-related value chain; and in resource-related industries. The AfCFTA is an important medium- to long-term opportunity for Africa, potentially attracting manufacturing business migrating from China. In many respects, whether the AfCFTA will succeed as a driver for African development will largely depend on its impact on regional integration, buttressing trade and developing nodes of growth. Even more powerful benefits will come if the dismantling of tariff barriers occur in conjunction with improving the efficiency of customs, tackle bureaucratic delays and reduce opportunities for corruption; and improving the management of economic corridors and invest in physical infrastructure and logistics networks (De Soyres et al., 2018:33).

South Africa's position

South Africa plausibly has the most to lose from greater competition with China on the African continent. South Africa has a relatively developed industrial sector – certainly the most scalable in Africa – accounting for one-third of Africa's manufacturing capacity. With an estimated USD16.5bn in imports from China in 2019, **South Africa is the largest consumer of Chinese products in Africa** – ahead of even Nigeria and Egypt. South Africa purchases around 14.9% of all the goods China sells to Africa.

Figure 8: Distribution of GDP growth in Africa



Source: IMF

Much like in other emerging markets with nascent manufacturing sectors, **the inflow of Chinese products has had a profound impact on a host of domestic industries in South Africa**. Granted, South Africa's own particular political and socio-economic difficulties have also served as headwinds (Naude, 2018:147). However, Edwards and Jenkins (2014:454) conclude that Chinese penetration of the South African displaced imports from other countries — but declines in domestic production accounted for the bulk of the increase. Losses in sales are particularly high in textiles and clothing, footwear and leather, electrical and electronic products and some types of machinery. Bongo-Bongo and Biyase (2018:11), find that imports from China have harmed both employment and value added of the manufacturing sector in South Africa over the past decade. The impacts have been seen not only in textiles, but also clothing, toys and household appliances (Morris & Einhorn, 2008:370), and, more recently, high-technology and machinery equipment (Edward & Jenkins, 2014:4). In short, imports from China do provide headwinds to employment, prices, inflation and wage growth (Sandrey and Jensen, 2007). It is clear that in the face of increased competition from imports, domestic firms were unable to defensively innovate by upgrading capital stock and upgrading skills.

South Africa's manufacturing sector not being dynamic is seen as a key factor explaining slow growth and high unemployment in South Africa (Rodrik, 2008). Since 2008, 3.5 million people have entered the labour force, but only 1.6 million additional jobs have been created. The unemployment rate has risen from 22.5% in 2008 to 29.1% in 2019. Nearly 6.2 million people are unemployed, or 9.3 million if those who have stopped looking for work are included. Including these discouraged workers, South Africa's unemployment rate is actually 38.5%. Of those looking for employment, as around 60% have not worked in the past five years – more than twice the number of just a decade ago. The manufacturing sector has the potential to absorb a notable share of the labour force. Consider, for example, Ethiopia where China's investments in manufacturing have been robust: employment levels grew from just about one million workers in 2004 to more than 5.6 million workers by 2015 (Naude, 2018:145).

Most important, failure to get the partnership right may marginalise South Africa from intra-Africa trade. Chinese goods have eroded the competitiveness of South African exports to its neighbours (Renard 2011:24). Being crowded out from Africa's growing consumption and rising middle-class is an acute concern. The risk is real as it is in South Africa's exports to Africa where Chinese competition is already fierce (Edwards & Jenkins, 2014:8). Yet, South Africa's long-term growth prospects (and perhaps relevance to China) is wedded to South Africa's relevance to Africa. Therefore, the manner in which South Africa coordinates its industrial and trade policy, and infrastructure, with other leading African economies, has become critically important.

For now, South Africa is often considered a preferred partner for Chinese firms. As such, **China's commercial footprint in South Africa is weighty, wide-ranging and multifaceted**. South Africa is China's largest export destination in Africa (Nigeria is close behind) and the largest source of imports from Africa (having usurped Angola in 2011). South Africa hosts the most outbound foreign direct investment (FDI) from China into Africa, even when China's largest investment in Africa – the sizable USD5.8bn purchase by the Industrial and Commercial Bank of China's (ICBC) purchase of 20% of Standard Bank Group – is excluded. South Africa has also amassed the largest share of China's greenfield investment in Africa (tallying nearly twice the size of its nearest rival on the continent cumulatively since 2001) – investments made by nearly 100 different Chinese firms across a range of sectors. Using this base as a platform, the next phase of China-South Africa ties and partnership must more forcefully and single-mindedly prioritize tactics for further industrialization, job creation and technology. **Attracting greater Chinese engagement and investment in South African manufacturing**, which includes not only the transfer of capital, but crucially the movement of firm-specific assets such as technology, managerial ability, corporate governance and access to the network connecting markets, **should be the overarching objective.**

Nevertheless, **boding well for the outlook for greater investment by China in South African manufacturing is private firms having driven China's commercial footprint in South Africa**, responding to economic incentives most swiftly – especially since 2013. Importantly, there is a material difference in the sector distributions of private- and state-led investments in Africa. First, private firms preferably invest in high-income and middle-income countries. Second, private firms tend to invest in manufacturing and services industries whilst SOEs are more likely to invest in construction and mining (Lu et al, 2011:224). Third, private firms are attracted to host-country strategic assets and are averse to economic and political risks when choosing investment locations abroad, whilst, state-owned enterprises follow the strategic needs of their home country and invest more in natural resource sectors, being largely indifferent to the political and economic conditions in the host countries (Amighini et al., 2012:20). Private companies are not creating establishments in government-sponsored special economic zones (SEZs), which are in fact struggling to survive (Pigato and Tang, 2015:8).

This is somewhat unique to South Africa. By and large, elsewhere in Africa, Chinese banks – specifically China Development Bank and the Export Import Bank of China – offer loans to African countries and SOEs to build infrastructure projects such as roads, dams, railways or industrial plants built by Chinese companies, manifesting in imports of related equipment and machinery, wide trade deficits; and gradual repayment of interest and sometimes principal's on loans back to China. However, Chinese loans to South Africa are relatively marginal – accounting for 2.3% of Chinese loans to SSA from 2000 through 2017 (Atkins et al., 2018). Rather, across South Africa private firms have already established operations in a diverse range of sectors including agriculture, autos, consumer electronics, industrial machinery and equipment, finance, metals and many more. On aggregate, their foray into South Africa is a sea-change from the path of Chinese firms interests in other parts of Africa, which has been weighted towards commodity acquisitions and largescale government-to-government negotiated construction contracts. The private-led footprint reinforces broader global trends and reflects both the relative wealth of South Africa and the maturity of South Africa's economy, institutions, corporates and depth of financial markets.

Even though African countries are relatively open to Chinese investment, which has been identified by Beijing as an important consideration in assessing total outward investment strategies, **the business environment in Africa remains challenging.** According to a survey of attractiveness for outbound investment, each of the seven

African nations assessed—Tunisia (48), South Africa (49), Egypt (51), Algeria (61), Kenya (65), Nigeria (66) and Angola (67)—ranked in the bottom third, out of 67 countries. Another survey, the Global Foreign Direct Investment Country Attractiveness Index, reported that South Africa's rank had deteriorated from 43 in 2013 to 48 in 2019. In particular, South African manufacturing, like across much of Africa, faces several stubborn obstacles. These issues include: access to finance, access to trade finance, complexity of tax system, customs and trade regulations, corruption, availability of qualified labour, labour regulations, employee health, reliable electricity supply, cost of electricity, transport costs, loss due to transport (breakage, theft, delays), physical infrastructure, ability to own land/premises, and physical crime (Kumar and Bergstrom, 2013:58).

South Africa has advantages. First, labour costs; for instance: the average wage in South Africa masks the country's high wage inequality. And, more than 5 million workers currently earn the minimum wage. Second, South Africa has an abundance of natural resources, essential inputs in production such as skins for footwear, timber for the furniture industry and land for agribusiness. Third, South Africa has an already substantial domestic market. Fourth, South Africa has favourable access to the region – a region which is experiencing rapid growth in their consumer markets, urbanising rapidly and enveloped in favourable demographics.

To fortify its current position, South Africa must make good on its commitment for improvements in the ease of doing business and competitiveness to create a better climate for partnerships. Improving the transparency of business regulations and the legal framework are important institutional factors that encourages Chinese outbound investment (McGregor, 2013:580). One of the specific targets set by South African President Cyril Ramaphosa as part of government's economic reform agenda, is **to improve the country's rank in the World Bank's annual global Ease of Doing Business survey to top 50**, from 82 in the latest assessment. Interestingly, China too has made tremendous progress in these areas, especially in the past three years. Over the past year, China ranked among the top 10 performers in implementation of reforms, improving 15 positions to rank 31 out of 190 economies. Improvement to the environment for doing business matters as many African countries are defiantly testing environments, and, as such, many Chinese firms prefer to business in South Africa.

Conclusion

Chinese firms have acquired both experience and expertise in its journey as "the world's factory", with Chinese policymakers right alongside. The Chinese economy is in a process of profound transformation by expanding more slowly and less factor- and investment-driven, rather shifting towards a pattern of growth driven by services and consumption; propelled by innovation; and with market forces determining the allocation of resources.

Ring-fencing China's South African engagements from China's trends would be impossible. South Africa must construct its policy framework to both ameliorate the more harmful impacts of China's internal adjustment as well as to benefit from developments underway in China. At the same time, Africa's promising structural drivers and the launch of the continental free trade area are alluring. Already some of China's fastest growing export markets are in Africa; from 2009-2015 nine of China's 15-fastest growing export markets were in Sub-Saharan Africa. Setting up production facilities – even if the starting point is on lower value-added assembly operations in the host nation – is a logical consideration for many Chinese firms.

A number of regionally minded hubs would be required to service Africa's internal demand. South Africa must position itself to this end and align diplomacy and concomitant metrics to a win-win bilateral partnership with China. South Africa has plenty to lose should Chinese firms choose to set up operations elsewhere – in Asia or

Africa – further eroding South Africa's position in intra-Africa trade. South Africa has already seen its manufacturing sector shrink as a share of GDP over the past decades. Instead, nearly 20% of South Africa's imports come from China, displacing imports from other countries, and at the expense of local production.

Turning this around will be critical for South Africa's commercial relevance in Africa, and for much-needed job creation and skills development in South Africa.

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Sub-Saharan Africa – tailwinds coming

Over the past 12-15 months, the global backdrop increasingly posed a headwind to the economic growth outlook for Africa. Uncertainty triggered by the US-China trade war, the removal of monetary policy support in some developed countries, together with outright tightening of monetary policy in others, contributed to downward revisions to consensus expectations for global growth.

There has been a long-standing expectation that economic growth among developed economies would decelerate in 2020 relative to 2019. At least, most forecasters have been anticipating that for a year. However, **overall GDP growth seems likely to accelerate in 2020 and 2021.**

Furthermore, we believe that global growth forecasts for 2020 and perhaps 2021 will be **revised upwards** over the course of this year. This is significant for the evolution of the economies of commodity-producing countries. The slowdown among developed countries was not the only reason economic growth in Africa's commodity producing countries failed to meet our expectations in the past year and a bit, but it admittedly was a significant factor. **It seems to have contributed to downside pressure on commodity prices in early 2019.**

However, for much of H2:19, commodity prices were bottoming out, especially base metals prices. **Copper** prices hovered around the USD6,000/MT level in late-2018. The recovery in early 2019 was cut short once prices got around USD6,500/MT in early 2019, and reverted to just below USD6,000/MT for much of H2:19.

Such downward pressure was understandable given the mounting anxiety about the global growth outlook precipitated by the US-China trade conflict. Consensus forecasts for copper prices were consistently revised lower in 2019. Yet, these have been revised higher since Dec, with consensus forecasts putting copper prices at USD6,200/MT at the end of this year, up USD450/MT from the forecast at the end of Dec.

We wouldn't be surprised to see these forecasts nudged higher this year. The theme of supply constraints keeps coming up among copper analysts. There has been occasional, isolated speculation that copper prices could rise above USD7,000/MT, although, clearly, that is not the consensus view. Be that as it may, it seems as if the risks are biased to the upside despite any volatility occasioned by geopolitical or trade shocks.

There is still plenty to suggest that oil prices will remain mostly above USD60.0/bbl over the next 4 – 6 months. Geopolitical strains, especially surrounding Iran, could keep prices elevated. Additionally, OPEC seems prepared to stick with production quotas to keep prices elevated.

Consensus forecasts for oil prices drifted marginally lower in Q4:19, with forecasts for the Brent crude oil price at the end of 2020 approaching USD60/bbl. But these are inching higher.

All this points to continued recovery among the continent's commodity producers. To be sure, some like Nigeria, require more than commodity prices to perk up. There are significant structural reforms that are required to ensure that the economy escapes persistently low growth. These reforms would need to address infrastructural bottlenecks in the economy, with the government needing to ramp up capital expenditure, among other things.

But Nigerian structural reforms, to the fuel industry for example, have progressed slowly over the past decade or so. It is difficult to pinpoint the source of such tardiness.

Perhaps those with a vested interest in the affected sectors can frustrate the legislative process that would effect these structural changes.

It is for this reason that one needs to watch several curious events in the recent past. The Central Bank of Nigeria (CBN) has been vociferous in pleading for credit extension to the real sectors of the economy to accelerate. There are various programs that are meant to stimulate domestic food production. The CBN prohibits domestic financial institutions from providing foreign exchange for the importation of certain items, among which are food items. Then, last year the federal government closed border posts connecting the country to neighbouring countries. This closure was purportedly to stop smuggling across the border. Among the items that the government wanted to target were food items. Unconventional as all these actions may be, they seem to leave policymakers with the conviction that they are helping to boost domestic food production.

The Angolan government has embarked on what could turn out to be a game-changing reform program. Since the collapse of oil prices in 2015, investment in the oil sector has been poor. The result is that oil production has been constrained, with mounting concerns among some industry players that oil production capacity may well peak and drop in the coming 5-y.

Therein lies the challenge for the government: attract investment in the sector, while simultaneously diversifying the economy away from the oil sector. To galvanise the latter, the government has indicated its intention to privatise several state-owned enterprises. To help that process along, they have made regulatory reforms to the functioning of the FX market, intent on ensuring that foreign investors can move funds in and out of the country with little hindrance. Crucially, they are not so keen to make it easy for portfolio investors in government paper.

There was drought that affected agricultural production in some countries in Southern Africa. In Zambia and Zimbabwe, the severity of the drought also constrained hydro-electricity generation. Rainfall in the current season seems to have normalised, with the volume of water flowing down the Zambezi River exceeding that of last year already, boding well for Zambian agricultural production (which contracted by 10.5% y/y and 5.1% y/y in Q1:19 and Q2:19 respectively).

Incidentally, of the countries for which there are Standard Bank or Stanbic Bank Purchasing Manager's Indices (PMIs), Zambia is the only one that has consistently shown contraction in economic activity over the past 2-y. PMIs for Ghana, Kenya, Mozambique, Nigeria and Uganda have all been mostly above 50, showing expansion in economic activity.

Global risk appetite: will likely support African economic growth

We expect elevated global financial markets and growth in developed economies to boost economic growth in Africa. A point worth reiterating is that capital flows to Africa will most likely support economic growth in the medium term. Of course, much of this is used for investment spending. African governments for example, can take advantage of buoyant financial markets to issue Eurobonds that are used for infrastructural development.

For the most part, **African countries face significant infrastructure deficits**. To address these, their task is made easier if market conditions are favourable. Without doubt, Risk assets have rallied tremendously since 2009, with some commentators now observing market frothiness. Yet others suggest that the US equity market rally specifically is the 'most unloved' in history. Evidently, the rally has benefited only a small section of the investing public, with large amounts of cash sitting on the side-lines. While a correction might be underway, with the scare due to the coronavirus outbreak weighing on market sentiment, **it is hard to say that the rally is ending**. This makes it more likely that African countries will be beneficiaries of these capital inflows.

African currency unions – much hype, little impact

It is worth pointing out that the East African Community (EAC), the Southern African Development Community (SADC) and the Economic Community of West African States (ECOWAS) have all, at some point or other, made a commitment to adopting a single currency by some stipulated deadline. Since 2000, all these trading blocs have made such commitments, then changed them, and recommitted to new dates.

We would not to say that these regional trading blocs won't ever promulgate common currencies. But one should separate regulatory pronouncements from political bluster. If a common currency is to be adopted in a region, then the central banks in that region would develop regulations and guidelines to effect the creation of such a common currency. Similarly, regulators for other business sectors, like pension funds, would also issue regulations affecting those industries. Once those have been communicated, compliance with them would be mandatory for all citizens of the countries in that trading block. Everything else would amount to speculation based on what may turn out mere political bluster.

But, considering that various pronouncements have been made over the last 20-y, is there any reasonable basis for one to determine if the current currency arrangements will be any different in another 5-y? Probably not. But it is perhaps a reasonable starting point to say that the probability of the status quo being maintained is closer to 100% than to 0%. Is there a way of telling if such a change, were it to happen, would be deleterious, and if so, an acceptable way of mitigating the risks now? Also, probably not.

It is always worth keeping in mind that the establishment of a common currency would be the result of a political process, a potentially long and tortuous process. This is also true of the XOF whose proposed reforms have been in the news recently. Sure, members of the Union Economique et Monétaire Ouest-Africaine (UEMOA) that use the XOF have taken decisions that will reform that arrangement. There will no longer be French representatives in the governance structures for the XOF. The region's FX reserves will be managed by the Banque Centrale des Etats de l'Afrique de l'Ouest (BCEAO) rather than having half of them pledged to the French Treasury. However, the latter would still guarantee convertibility of the XOF.

Notably, these changes are meant as preparation for the adoption of the ECO as a single currency for ECOWAS, which is made up of UEMOA and the West African Monetary Zone (WAMZ). Crucially, members of the WAMZ have their own currencies. Nigeria has a GDP that is about 40% of ECOWAS. Presumably, adoption of a single currency would not be a replication of the XOF mechanism for the entire ECOWAS.

After UEMOA made its announcement regarding the reform to the XOF arrangement, the WAMZ issued a statement denouncing the UEMOA announcement as unilateral. Ironically, the federal government in Nigeria has closed some border posts to neighbouring countries, hampering trade and movement of labour. It is not easy to argue that the adoption of the ECO by all members of ECOWAS is imminent.

Political risks: light electoral calendar in the next 4-m

Only a handful will hold general elections in H2:20. The Tanzanian general elections will probably generate a fair amount of noise. In the past, the ruling party tended to win rather comfortably, amid the opposition's allegations of vote-rigging.

It remains to be seen if the ruling party will put forward policy proposals that are a significant departure from current policies. Of course, a number of policy issues could turn out to be pivotal for medium-term economic performance. Perhaps chief among these is the development of the natural gas sector. But the general regulatory backdrop, that has made it difficult for foreign companies to operate in the country, is crucial too.

The Ethiopian elections will also be crucial ones to watch. If anything, they could be a clear sign of whether the Prime Minister's reform agenda has any grassroots support. He has been widely lauded outside the country for the bold reform moves he has made and for advancing peace. With respect to the latter, he went on to win the Nobel Peace Prize. That said, regional representation in government tends to be a particularly thorny issue.

An argument can be made that Ghana's elections do not represent such a huge risk. After all, the electorate has switched between the NPP, currently in power, and the NDC since multi-party democracy was introduced in 1992, giving each party 2 terms in power. So, if the NPP were to be voted out of power, then this would be a significant departure from history.

The key concern for the market is that the NPP will essentially try to buy the elections by boosting government spending, whether it be recurrent or capital expenditure. Yet the government observed the Fiscal Responsibility Act in budgeting for a 4.7% of GDP fiscal deficit this year. Admittedly, the revenue assumptions may have been somewhat optimistic, requiring that the government restrain spending. Therein lies doubts for the market: expenditure restraint, and, in an election year? Regardless, preliminary data shows that there was spending restraint in 2019, with the government achieving the originally budgeted 4.2% of GDP fiscal deficit.

Côte d'Ivoire's elections are highly unpredictable, something that is likely to keep the market apprehensive. As is the norm, coalitions will be formed in the run-up to the elections. Yet, at this stage it is not clear how these will be composed. President Ouattara, who is serving his second term, and should thus be ineligible to be president, has not announced whether he will run or not. He has previously pointed to what he considers to be grounds to allow him to run again due to the new constitution introduced in 2016. Apparently, he will announce his intentions in Jul.

Furthermore, Guillaume Soro, the former President of the National Assembly who fell out with President Ouattara and has been positioning himself for a presidential run, faces an arrest warrant. The public prosecutor alleges that he was involved in a coup plot last year. Recall, it was Soro and his fighters that turned the tide against Laurent Gbagbo during the civil war in 2010, allowing Ouattara to capture the presidency.

FX outlook

In the past 4-m, the currencies that depreciated the most were the AOA that depreciated by 25%, the ZMW that depreciated by 10.1%, and the ETB that depreciated by 7.9%.

The USD/AOA move is still mostly policy-determined. Even though the directional bias to the pair is still to the upside, policymakers are looking to provide enduring support to the economy as elaborated above.

Since trading mostly in a 9.50 – 10.30 range between Mar 16 and Sep 18, USD/ZMW has risen in a stepwise fashion to trade in a range of 14.00 – 15.00 since the beginning of the year. All told, the pair has risen at about a 29% annualised pace since Sep 18.

It is hard to see this rising trajectory terminating or reversing. To be sure, copper prices have recovered somewhat. It seems highly probable that the hydro electricity generation will improve over the next 2-y. This revival might be sufficient to bolster copper production as well, in addition to agricultural production, thereby supporting the BOP. Copper export volumes fell by just over 20% y/y in the 11-m to Nov 19, with electricity supply constraints probably a factor behind this decline. However, there is no end in sight to the strong demand for FX to fulfil the government's external debt service obligations. The Bank of Zambia made some USD1.17bn in external debt service payments in the first 11-m of 2019. Budgeted external debt service payments are budgeted to be in excess of USD1.5bn in 2020.

The ETB is not typically among the currencies that depreciate the most on the continent. But the pace of depreciation has picked up in recent months. Usually, the central bank devalues the ETB by a large amount once every few years, then keep the pace of depreciation fairly low, about 5% on an annualised basis.

The movement of the exchange rate in recent months seems like quite a departure from this. Perhaps this departure is understandable given the economic reform program of the government. This program is being supported by a 3-y Extended Credit Facility and an Extended Fund Facility from the IMF. Among the aims of the program are exchange rate reforms to address FX shortages and increase FX flexibility.

The 13.1% depreciation of the GHS in 2019 is the first double-digit pace of depreciation since the 13.9% depreciation in 2015. Of course, 2015 was a pre-election year. The GHS depreciated by 9.2% in 2016. Arguably, the market may have been somewhat mollified by the existence of an IMF-funded program at that time. The government was on a fiscal consolidation path.

Could the upcoming elections in 2020 be a factor pushing USD/GHS materially higher? While, many investors have expressed trepidation at the prospect of an election while the government is without an IMF-funded program, such trepidation has not translated into a notable reduction in exposure to GHS bonds. The Central Securities Depository indicates that foreigners were holders of GHS29.07bn in GHS bonds in Dec, compared with GHS27.26bn in Nov. Throughout 2019 the average was close to GHS27.5bn. The peak was GHS29.22bn in Apr 18.

Of course, the BOG was steadfast in its determination to intervene to keep USD/GHS from rising in a disorderly fashion. It has helped that the government has been willing to issue Eurobonds quite early in the year, granting the BOG the ability to boost FX reserves and use those to intervene in the FX market. The government aims to issue Eurobonds early this year, as it did last year.

The East African shillings continue to exhibit broad stability. We see little impetus to change this over the next 4 – 6 months. The KES might enjoy some support in early Q1:20 due to flower export sales. That might reverse somewhat in Q2:20 due to dividend payments. There will be elections in early 2021 in Uganda. Pre-election noise has typically exerted some pressure on the UGX. But this typically fizzles out closer to elections.

The desire of policymakers to maintain USD/NGN in a narrow 360 – 365 range is undiminished. If oil prices hold around USD60/bbl, there shouldn't be much trepidation on their part. However, FX reserves have fallen rather sharply, to just under USD38.3bn in early Jan from over USD45.0bn in Jul. Import demand has picked up notably, fuelled by capital imports as some capital expenditure projects advance.

Phumelele Mbiyo#

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SA Politics in 2020 – a balancing act

In providing structural economic steer, President Ramaphosa will need to carefully balance competing and often conflicting interests from the various stakeholders that he has since his election as party leader in December 2017 sought so routinely to placate

The year ahead may be a defining one politically. A relatively rare election-free calendar (Table 1) may allow a more assertive stance from government in resolving some of the country's pressing structural challenges. Yet, in providing such steer, President Ramaphosa will need to carefully balance competing, and often conflicting, interests from the various stakeholders – in the ANC, government, business, civil society, and the labour movement, amongst others – that he has since his election as party leader in December 2017 sought so routinely to placate.

Table 1: Key elections

2019	2020	2021	2022	2023	2024
National and provincial elections	Nothing scheduled	Local Government Elections (likely Aug/Sep)	ANC elective conference (Dec)	Nothing scheduled	**National and provincial elections**

Source: Standard Bank Research

It is likely that the president will continue to err on the side of caution in this regard, offering incremental – though still meaningful – progress on matters related to economic policy and SOE restructuring. Critical trade-offs will likely become more apparent in 2020: though government is unwilling to consider meaningful job cuts at, or direct privatisation of, Eskom, it is nonetheless pushing forward with the utility's unbundling and is evidently intent on supporting the deregulation of the energy sector, thus enabling far stronger private sector participation in electricity generation in order to alleviate the damaging effects of load-shedding on growth and confidence. From a managerial perspective, some progress this year can also be expected at key SOEs such as Eskom (which has a new CEO and chairperson); SAA (which was placed into business rescue late last year); and Prasa (which has been placed under administration).

The effects on the public mood of another lacklustre year economically will be somewhat softened by the ongoing and important institutional rebuilding of critical Anti-Corruption Task Team institutions this year

The effects on the public mood of another lacklustre year economically will be somewhat softened by the ongoing and important institutional rebuilding of critical Anti-Corruption Task Team (ACTT) institutions this year. Focus in this regard will fall on the National Prosecuting Authority's Investigative Directorate, which in December last year arrested a group of former Eskom executives related to an allegedly improper contract at the Kusile power station. The Directorate has also announced that it has concluded its forensic investigation into the Gupta-linked Estina Dairy Farm project and that it will soon formalise charges in relation to this investigation. It is plausible that the Special Investigative Unit (SIU) will conclude its interrogation of various potentially irregular (and state capture related) contracts signed by Eskom and Transnet executives this year, too. Here, public interest will perhaps rest most squarely on Eskom's facilitation of the Gupta family's purchase of Glencore's Optimum coal mine in 2016. These developments will bolster the, already visible, signs of institutional regrouping that emerged in 2019 from ACTT institutions. Here, the president's thorough 'due process' approach towards governance reform is having an unambiguously positive effect in shoring up institutional credibility and closing the avenues for reprisal for those most directly threatened by the state's ethical recalibration.

Within the ANC, a dense calendar of potentially shaping party elections and events this year presents the opportunity for President Ramaphosa's currently firm grip on power within the party to be either further shored up or diminished. The president enters the year in a position of political strength, based on the support he holds within the majority of ANC provinces and across its alliance partners, and as a function of the systematic manner in which former president Zuma's party power base has been dismantled – and its access to patronage diminished – over the past two years. Nonetheless, the factional sway of influence in the ANC is never static, and it could be reshaped this year should the president's adversaries secure a new institutional foothold around which they can frame their battle against his reform initiatives and so potentially weaken his 2022 re-election aspirations. Here, the focus will rest on the National General Council (NGC) in June, during which ANC members will discuss the leadership's progress in implementing its 2017 resolutions; as well as on seven potentially vital party elections scheduled for 2020. These are for new leadership of the ANC Youth League; the ANC Women's League; the ANC's provincial leadership in Mpumalanga, the North West and the Western Cape; and for new regional leadership in eThekwini (which in large part shapes the balance of power in KZN), and OR Tambo in the Eastern Cape.

Table 2: ANC provincial election schedule

Province	Current chairperson	Current premier	Share of ANC m/ship (2017)	Next provincial election
Eastern Cape	Oscar Mabuyane	Oscar Mabuyane	13.7%	2022
Free State	Sam Mashinini	Sisi Ntombela	8.6%	2023
Gauteng	David Makhura	David Makhura	10.7%	2023
KZN	Sihle Zikalala	Sihle Zikalala	18.4%	2023
Limpopo	Stan Mathabatha	Stan Mathabatha	13.6%	2023
Mpumalanga	Mandla Ndlovu (acting)	Refilwe Mtsweni-Tsipane	15.6%	2020 (scheduled for March)
Northern Cape	Zamani Saul	Zamani Saul	4.2%	2022
North West	Vacant (led by task team)	Job Mokgoro	11.4%	**2020**
Western Cape	Vacant (led by task team)	Alan Winde (DA)	3.8%	**2020**

Source: Standard Bank Research; ANC

Elsewhere, focus will undoubtedly rest on several key legal and constitutional battles this year. Most prominently, the year may see the first amendment to the Constitution's Bill of Rights, provided the ANC is successful in nudging through its proposed amendments to Section 25 to more "explicitly" enable the expropriation of land without compensation. Various opposition political and civil society groupings are already gearing up to challenge the constitutionality of the ANC's approach in this regard, as well as with other recent legislative amendments by government, such as the Traditional and Khoi San Leadership Act and the recently gazetted amendments to the Refugee Amendment Act. These challenges – particularly to the amendment of Section 25 – will very likely delay the process of change.

Several politically shaping court processes are likely to play out in the year ahead, too. Of central focus will be the separate reviews by President Ramaphosa and Minister of Public Enterprises Pravin Gordhan into the adverse findings against them by Public Protector Busisiwe Mkhwebane. Adv. Mkhwebane's tenure will also be formally tested by the parliamentary proposal to remove her that was initiated by the Democratic Alliance (DA) last year, and which will be debated in the National Assembly in 2020. Both Economic Freedom Fighters (EFF) President Julius Malema and his deputy Floyd Shivambu will face separate charges in court this year, too, the outcomes of which may imperil their ability to remain members of parliament.

From a labour relations perspective, focus in terms of the scheduled collective bargaining processes in 2020 will fall on negotiations in the coal sector and in the metals and engineering industry given the expiry of both deals at the end of June

From a labour relations perspective, focus in terms of the scheduled collective bargaining processes in 2020 will fall on negotiations in the coal sector (where the NUM is the dominant union) and in the metals and engineering industry (where NUMSA is dominant) given the expiry of both deals at the end of June. Aside from this, tense public sector wage talks will likely begin towards the end of the year, with unions likely battling to secure above-inflation gains given the profound fiscal constraints that government faces. More broadly, organised labour will attempt to regroup in the years ahead after a bruising previous decade. While COSATU will continue to seek influence through the tripartite alliance and based on its relationship with President Ramaphosa, other unions and federations (such as AMCU, NUMSA and SAFTU) may look to build new political affiliations – potentially with the EFF – in order to elevate their national voice.

Table 3: Collective wage negotiations

Sector	Main union(s) + federation	Most recent wage deal struck	Expiry of current agreement
Automotive (manufacturing)	NUMSA (SAFTU)	2019	30 June 2022
Automotive (retail)	NUMSA (SAFTU)	2016	**Still in negotiations for a new three-year deal**
Chemicals	CEPPWAWU (COSATU)	2019	30 June 2021
Gold	NUM (COSATU); AMCU (NAFTU)	2018	30 June 2021
Platinum	AMCU (NAFTU)	2019	30 June 2022
Coal	NUM (COSATU)	2017	**30 June 2020**
Public sector	Various, mostly COSATU or FEDUSA affiliated	2018	30 March 2021
SALGA (local government)	SAMWU (COSATU)	2018	30 June 2021
Metal and Engineering	NUMSA (SAFTU)	2017	**30 June 2020**
Eskom	NUM (COSATU); NUMSA (SAFTU); Solidarity	2018	30 June 2021

Source: Various media reports and union/employer statements; Andrew Levy Employment; Standard Bank Research

Within the opposition, in 2020 the DA will look to regroup after a disastrous 2019. The focus for the party will be in shoring up its conservative minority core through the election of new leadership in May, and the tabling of firmer resistance to ANC and government policies such as land expropriation and National Health Insurance. For its part, the EFF will focus in 2020 on defending its president and deputy president from prosecutorial action; sowing and then benefiting from factional rifts in the ANC; and securing new 'leftist' alliances within the trade union movement to elevate its national appeal. Both the EFF and DA (as well as other opposition parties) will also seek to renegotiate the alliances that were disrupted last year in metros such as Nelson Mandela Bay and Tshwane.

Concluding remarks. We expect mixed political economy progress in 2020: reform at Eskom and across other troubled SOEs will be incremental rather than decisive and contentious, with the associated risk that socio-economic tensions compound over the medium term and complicate the policy environment in the 2021 local government elections, the 2022 ANC leadership elections, and the 2024 national and provincial elections. However, the president's cautious demeanour is being far more positively reflected in both the prospects for ongoing anti-corruption momentum from institutions such as the SIU, the Hawks and the NPA, and in the rebalancing of power in his favour (and/or in the favour of institutional 'unity') in the ANC. In these two areas we expect that the year will end with firmer confidence on the state's governance reboot and on President Ramaphosa's capacity to secure re-election as party president in 2022. Similarly, it can be expected that the courts to again hold the line in the year ahead on matters of primary political and/or constitutional importance, in so doing emphasising the profound role the judiciary – as well as the civil society organisations that represent groups affronted by potentially unlawful and unconstitutional government action – plays in defining South Africa's

*Simon Freemantle**

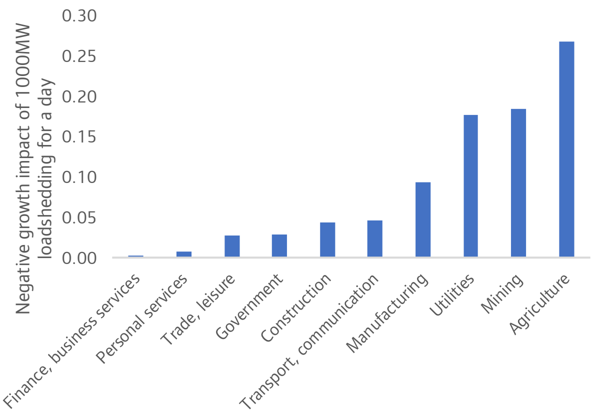
* Analyst certifications and important disclosures are in the disclosure appendix. For other important disclosures, please refer to the disclosure & disclaimer at the end of this document.

SA economic growth: political hostage

In a nutshell: politicians and Eskom key 2020 growth determinants

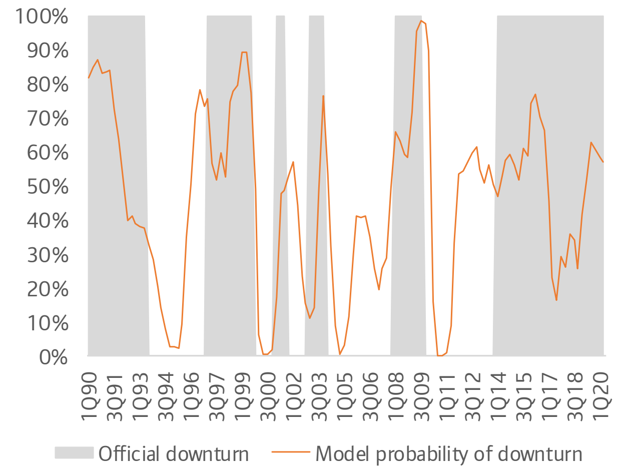
The fiscal and electricity crises clearly mean that government should not delay decisive policy reforms. Thus far, government's growth-supportive adjustments have comprised focused, uncontentious policy steps, which haven't been adequate to lift confidence from its lowest levels in decades. The marginal growth improvement that we foresee in 2020 to a large extent reflects an assumption that the weakness or contraction in select sectors will ease, rather than any meaningful new growth impetus. This is premised on a similar magnitude of electricity load-shedding to 2019. While there are many caveats and reasons for non-linearity, we estimate that every day of stage one (1,000 MW) load-shedding reduces annual economic growth by around 0.015%.

Figure 1: Load-shedding impact – goods-producing sectors typically hit hardest



Source: SARB

Figure 2: Econometric business cycle model still estimates more than even chance of very weak growth through 1H20



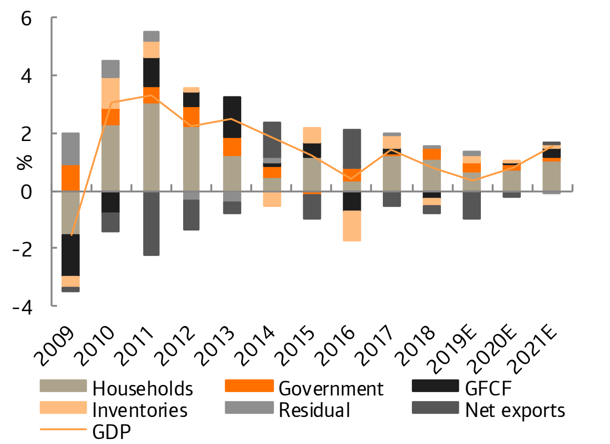
Source: SARB, Standard Bank Research

At the end of 2019, government invited private sector proposals by January 2020 to add 2,000 – 3,000 MW of least-cost new generation capacity, while there should also be around 2,400 MW of new generation capacity from Eskom and the latest round of renewable energy. The crux, however, is in the operational performance of the existing plants, which operated at an energy availability factor (EAF) of only 56.8% at the beginning of 2020. Eskom foresees no load-shedding if unplanned outages don't exceed 9,500MW, though at 11,500MW it foresees likely stage one to two load-shedding in 1Q20 (early in 2020 this was as high as 14,000 MW).

The electricity shortfall clearly poses a major risk to the private sector's fixed investment trajectory, though we still assume that there will be gradual traction with the commitments made during the presidential investment summits and Public-Private Growth Initiative (PPGI) as well as ongoing roll-out of the renewable energy independent power producers' (REIPP) capex. Sovereign credit downgrades from all the major credit rating agencies are on the cards in 2020, which might also weigh on confidence, though we are more concerned about the negative confidence and growth ramifications if government doesn't decisively reduce concerns about fiscal sustainability and Eskom than we are about the impact of the rating downgrades per se.

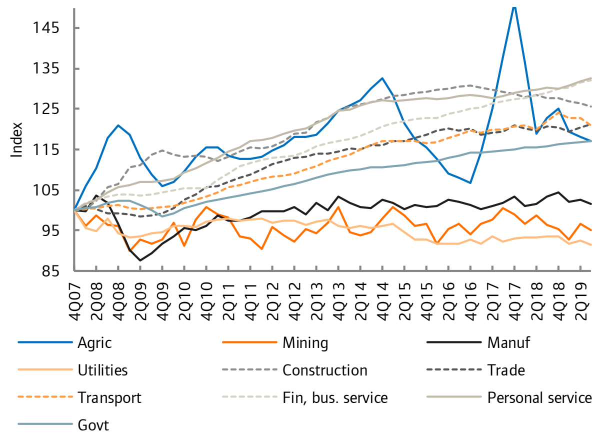
From a supply-side perspective, growth should mainly be driven by the services sectors in 2020, given our assumption that the electricity supply constraint will continue to curb growth in the goods-producing sectors. Our forecasts incorporate a marginal improvement in the contribution from the agricultural sector, though this is at risk as rainfall forecasts continue to weaken (see analyst Penny Byrne's report It never rains but it pours). The mining and manufacturing sectors are to a large extent at the mercy of Eskom's operational performance.

Figure 3: Growth still driven by consumer momentum



Source: SARB, Standard Bank Research

Figure 4: Growth driven by services sectors

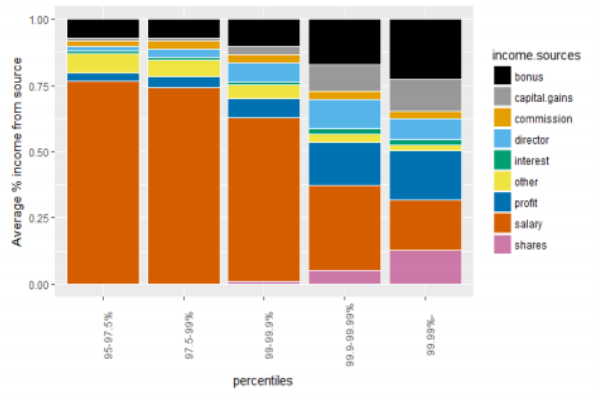


Source: SARB, Standard Bank Research

Consumer spending: a fragile, uneven growth contributor

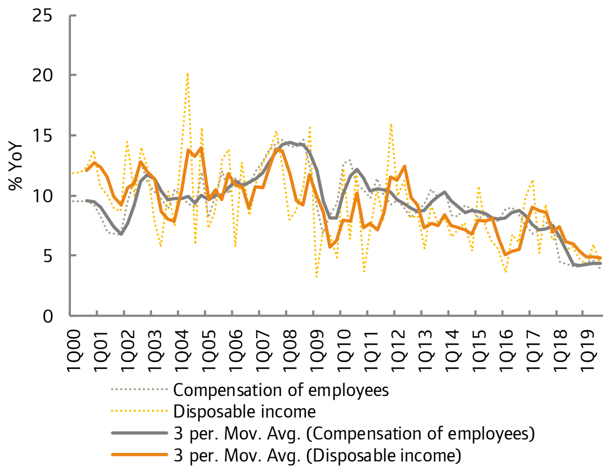
Consumer spending growth is still supported by real income growth despite our growing concern about the weakness in employment as well as skilled emigration. Higher-income earners seem to continue playing a disproportionate role in driving aggregate consumer spending. Their spending power has been, according to our analysis, strongly supported by non-wage income, particularly investment income, and they have also typically received above-average real wage growth in the past.

Figure 5: Composition of households' income – non-wage income constitutes around 50% of top earners' income



Source: Bassier and Woolard (2018)

Figure 6: Non-wage income has been supplementing consumers' wage income (with disposable income growth stronger than wage growth)

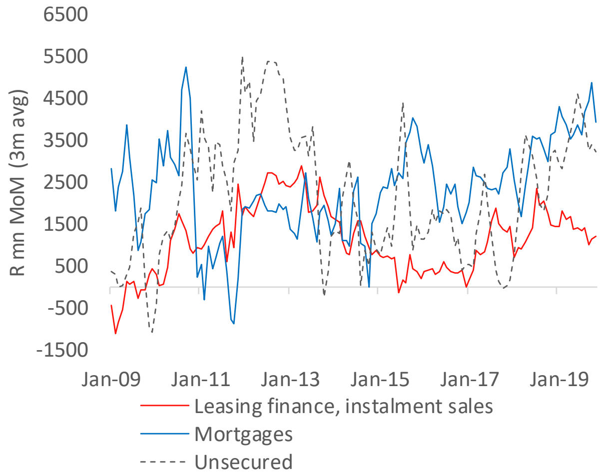


Source: SARB, Standard Bank Research

A key driver of consumers' spending power is credit growth, which our analysis[1] suggests is primarily driven by mortgage growth of the higher income groups and unsecured loans of the lower income groups (see Consumers still supported but fragile). There are already signs that the latter group is under pressure, with a growing number of borrowers with reasonably small debt burdens falling into arrears[2]. In contrast, the arrears of high-income borrowers remain quite low and their debt growth has mainly been in respect of mortgages. The credit impulse may thus in due course lose momentum insofar as unsecured loan growth should fade.

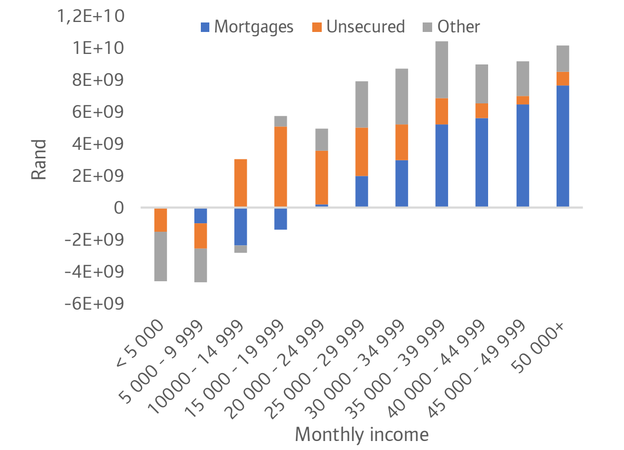
[1] *Based on data from one of the credit bureaus, which is not nearly as robust as official data and needs to be used with caution.*
[2] *The growth has also been supported by a shift downwards on the credit-score scale, though this seems to have stalled in the latest (3Q19) data.*

Figure 7: Households' (seasonally adjusted) credit growth remains strong, mainly owing to sturdy mortgage growth



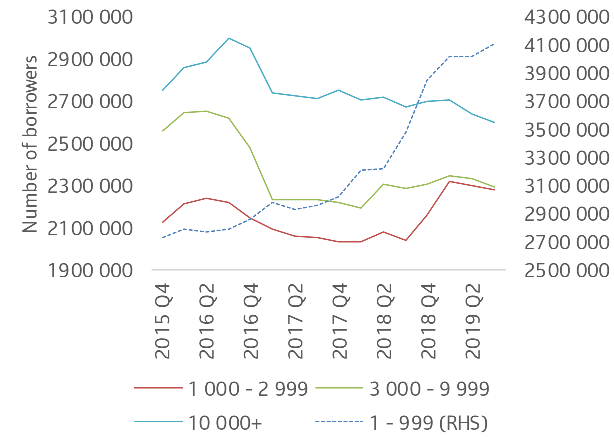
Source: SARB, Standard Bank Research

Figure 8: Household credit fuelled by mortgages of middle- to high-income earners and unsecured loans of low- to middle-income earners



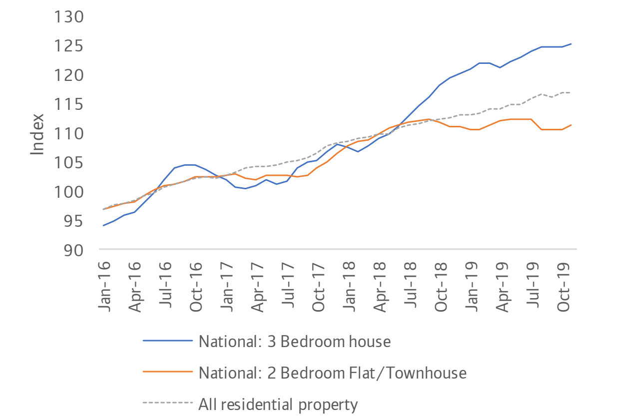
Source: SARB, Treasury, Standard Bank Research

Figure 9: Overdue loans rising most for people with small loan balances, implying stress in lower-income groups



Source: XDS, Eighty20, Standard Bank Research

Figure 10: House price increases stronger for larger houses, consistent with stronger finances of higher-income groups



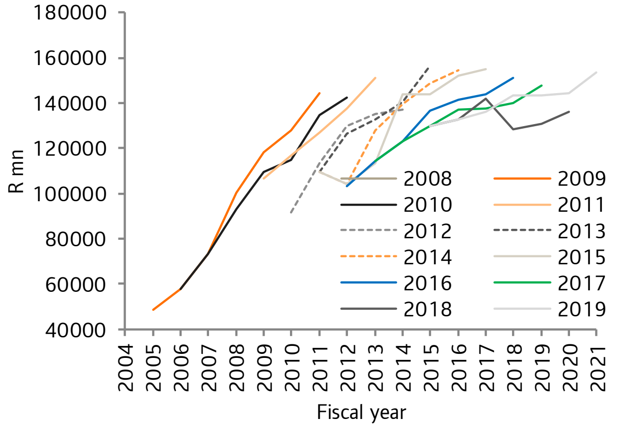
Source: XDS, Eighty20, Standard Bank Research

Fixed investment likely to remain weak and fragile

Public-sector infrastructure spending growth is likely to remain weak in the short to medium term, with constrained SOE funding positions, limited fiscal space, long-standing capacity constraints and unintentional delays created by anti-corruption efforts. The growth in infrastructure spending will be modest – only 2.8% YoY in 2020 – if *all* the projected capex takes place (without any underspending, which may very well continue). This is consistent with the prevailing weakness in construction companies' perceptions of activity levels. We remain optimistic about an increase in private sector participation in infrastructure construction (and potentially maintenance and operations) of which the first concrete steps have manifested in the Infrastructure Fund allocation in the 2019 MTBPS. The profile of the Infrastructure Fund's spending – which starts very modest before growing in the longer term[3] – aptly reflects how slow this process will likely be.

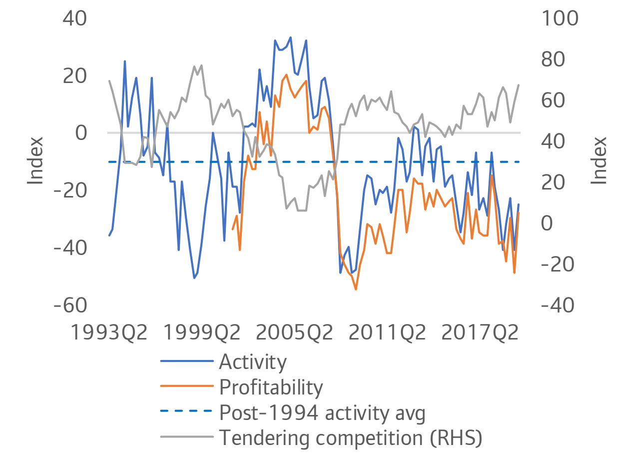
[3] *Government allocated R0.5bn to the fund in FY19/20, with R10bn projected over the three-year forecast period and an ultimate aim of R100bn over a decade.*

Figure 11: Government infrastructure underspending is likely to continue



Source: Treasury, Standard Bank Research

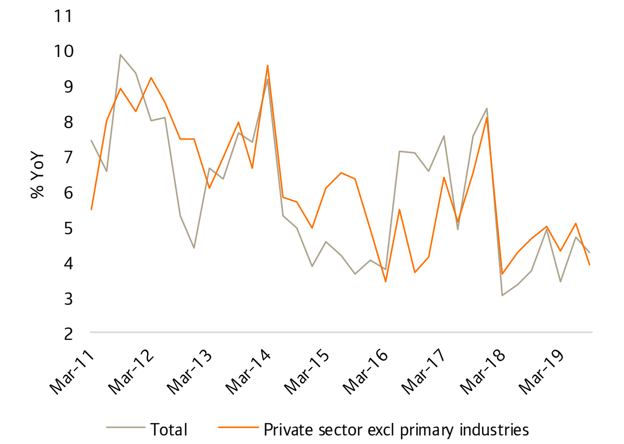
Figure 12: Construction companies' perceptions of activity levels improved but remain weak



Source: BER

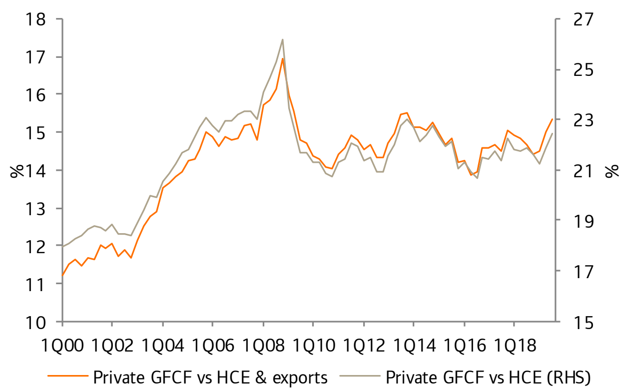
Private-sector fixed investment should, as in 2019, again be supported largely by specific projects, notably the renewable energy programme and commitments made at the president's Investment Summits. Our view remains that the popular thesis, that a resumption of maintenance or replacement investment will spur an acceleration in private-sector fixed investment, is misplaced as real capital stock levels continue to rise (in all sectors bar manufacturing). Faster capacity expansion is thus required for a larger economic growth contribution from the private sector's fixed investment.

Figure 13: Gross operating surplus (profit proxy) not providing strong support for fixed investment growth



Source: Stats SA, Standard Bank Research

Figure 14: Private sector fixed investment not low vs total demand

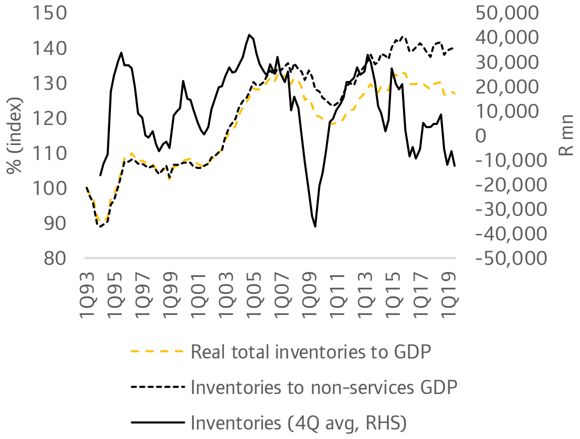


Source: SARB, Standard Bank Research

Inventory restocking unlikely to be a big boost

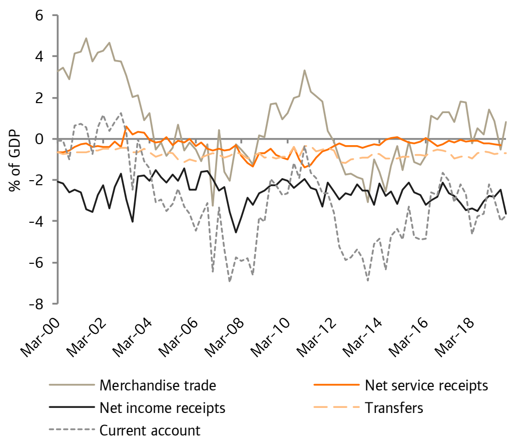
Inventory destocking has been comparatively mild in the current economic downturn and we expect a similarly subdued restocking cycle to follow. We therefore don't expect any meaningful boost to economic growth from inventory rebuilding.

Figure 15: Real inventories to GDP not meaningfully lower than at the start of the current official downturn



Source: SARB, Standard Bank Research

Figure 16: CAD supported by trade improvement



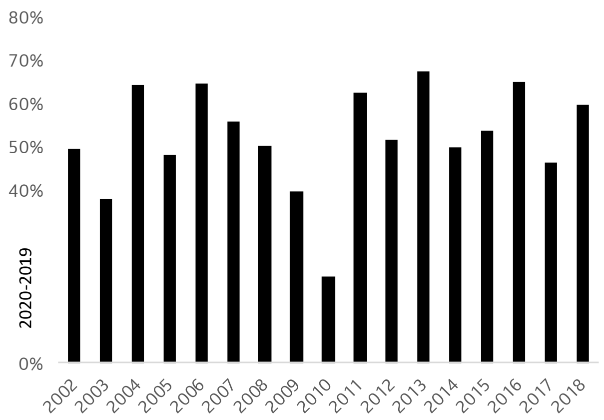
Source: SARB, Standard Bank Research

Trade and the CAD supported but vulnerable

Net (real) trade volumes should benefit from a relatively competitively valued rand in 2H18 – 2019 and the forecast acceleration in SA's trading partners' growth in 2020. Export growth will, however, be capped by the electricity constraint. Imports, meanwhile, will be generally weak given the expected weakness in domestic demand, except for the boost from capex imports related to specific projects such as the renewable energy expansion investment. It is difficult to disentangle the impact of idiosyncratic factors, such as load-shedding, and global factors, such as the trade war, on export weakness. However, our disaggregated analysis of SA exports' global market share underscores the importance of local factors insofar as exports have generally been losing global market share. The strong terms of trade are masking the deterioration in the real goods and services trade balance.

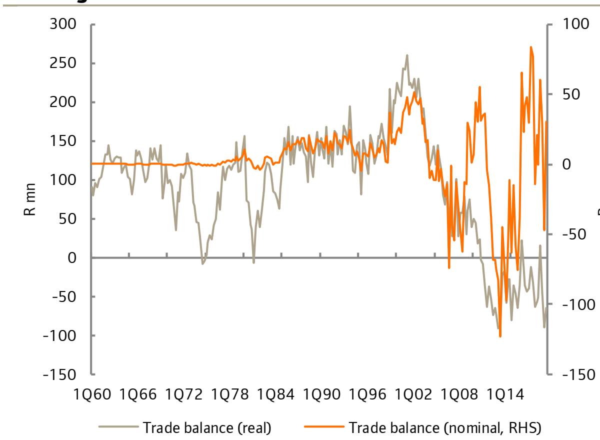
Amid a material improvement in the nominal trade balance, the rest of the current account deficit has deteriorated in recent years. This is largely owing to the widening of the income deficit (comprising investment returns), according to the SARB's (official) estimates, underpinned by the estimated expansion of non-residents' investments in SA. We expect the current account deficit (CAD) to remain reasonably small in 2020 (especially once the SACU payments are excluded).

Figure 17: Proportion of categories losing global market share (YoY) - broad-based global market share losses[4]



Source: Bloomberg, Standard Bank Research

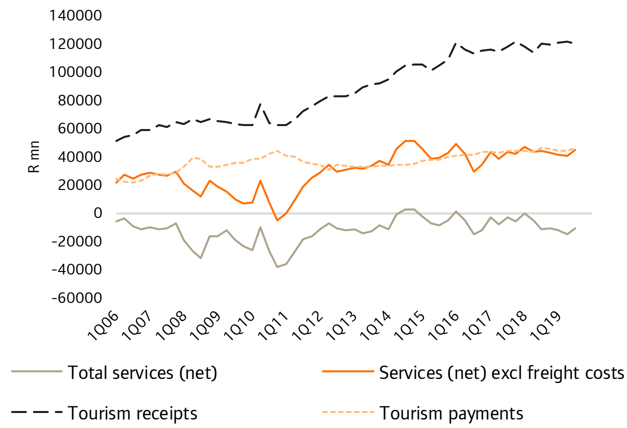
Figure 18: Record-high terms of trade masks the weakness in real goods and services trade



Source: Bloomberg, Standard Bank Research

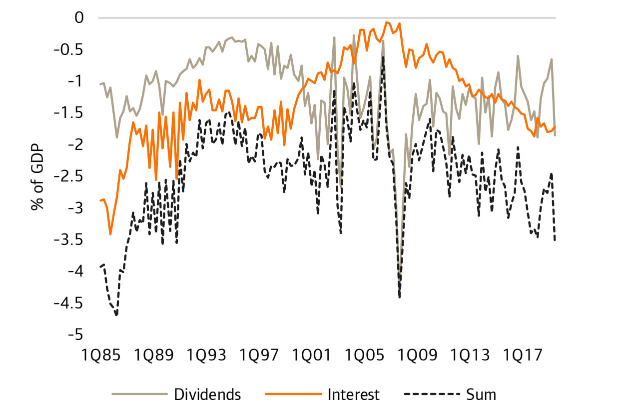
[4] *This is the cumulative impact on revenues from year-to-year market share changes across 255 categories.*

Figure 19: Tourism inflows support the CAD



Source: SARB, Standard Bank Research

Figure 20: Net dividend and interest payments high



Source: SARB, Standard Bank Research

Fiscal and rating risks high

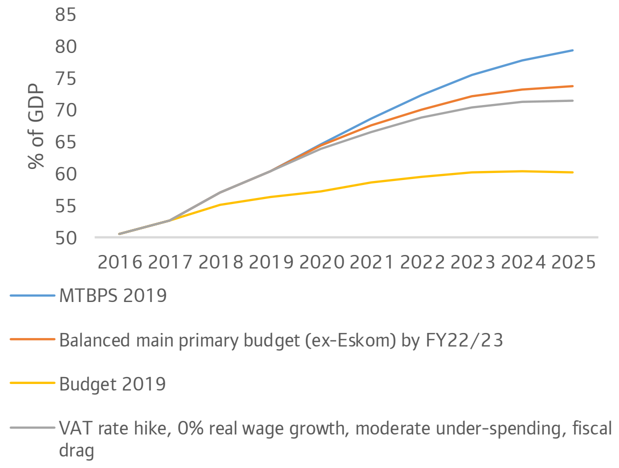
The magnitude of the fiscal shortfall implies that trimming at the edges is no longer adequate, the large expenditure items – specifically the wage bill and ongoing cash injections for SOEs – need to be addressed. Finance Minister Tito Mboweni's tough stance on SOEs and the ongoing pursuit to unwind state capture is encouraging, though we'll only get clear guidance on the political will to resolve the fiscal and SOE problems this year, when the business rescue at SAA unfolds and steps have to be taken to avoid the extent of fiscal deterioration predicted in the MTBPS.

There will obviously be strong opposition from factions within the ruling party and tripartite alliance to any wage bill curbs[5]. While a freeze of government wages, which we estimate could save around R50bn in FY22/23, is one of the proposals to be discussed, we see this as a very improbable outcome. We see CPI-linked wage growth, which will save around R35bn in FY22/23, as a more realistic assumption.

We assume that, through a combination of curbing the wage bill, cutting other spending and hiking taxes, government will achieve Treasury's proposed balanced main primary budget (excluding Eskom) in 2022, though this cannot be taken for granted. Even full implementation of the proposed adjustments will still see the government debt-GDP ratio rise to above 70% (*ceteris paribus*). The debt servicing cost will increase to around R300bn by FY22/23 from around R200bn in FY19/20 – this compares to annual social grant spending of around R210bn - R220bn and around R160bn of total government infrastructure spending. Clearly, such a debt service burden, which excludes the impact of the planned National Health Insurance (NHI) and transfer of Eskom debt onto the government balance sheet, is undesirable and sub-optimal spending (see MTBPS: further thoughts).

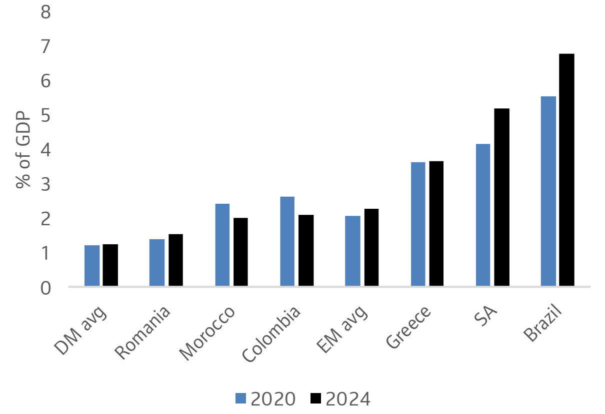
[5] The current wage settlement extends through FY20/21, so we rule out cuts to the wage bill in 2020 though subsequent forecasts may be trimmed.

Figure 21: Government debt should settle below MTBPS forecasts, though unlikely below 70% of GDP



Source: Treasury, Standard Bank Research

Figure 22: SA debt servicing cost high in absolute and relative terms



Source: Treasury, Standard Bank Research

Treasury strongly argues that, apart from addressing the remaining fiscal leakage, spending cuts are increasingly challenging following several years of trimming, though it foresees some savings from suspending the implementation of new transport networks in planning stage for over a decade without roll-out of services to residents; consolidating entities and regulatory agencies; disposing of unused land and other assets; and curbing benefits received by political office bearers through Ministerial Handbook reforms. We also foresee further modest capex underspending.

At the same time, government is increasingly reticent to increase taxes following several years of hikes and a general acknowledgement of its inefficient spending. Nevertheless, we foresee more tax hikes this year and, despite households' tax burden rising to the highest in decades, this will likely be borne largely by consumers. This will include near-full fiscal drag (not adjusting tax brackets for inflation), supplemented by modest revenues from higher excise duties on alcohol and tobacco products and fuel levies. There is a strong probability of another VAT rate hike, though we suspect that the president would want to avoid this given the political capital that he will have to spend on other politically unpopular reforms such as SOE overhauls and a reduction of the government wage bill. Dividend or capital gains tax might also be increased, rather than to impose an administratively challenging wealth tax.

Figure 23: Select tax hike options and considerations for Budget 2020

Tax	Revenue boost	Probability
Fiscal drag	At least R13bn	Very high probability
Fuel levies	R3bn	Very high probability
Duty on alcoholic beverages and tobacco (jointly)	R1bn	Very high probability
Estate duties and donations tax	R1.3bn for a 10ppt increase	High probability
Medical tax credits	R1bn	High probability
Wealth tax	R5-8bn	Moderate probability
Dividend tax rate	R8bn for a 5ppt increase	Moderate probability
Capital gains tax rate	R2bn	Moderate probability
VAT rate	± R12bn for every 0.5ppt increase.	Moderate probability
Top marginal income tax rate		Moderate probability
Personal income tax rate increase	±R9.5bn for 1ppt increase	Low probability
Graduate tax	R200m – R3bn	Low probability
One-off levy		Very low probability
Company tax rate		Very low probability

Source: Treasury, Standard Bank Research

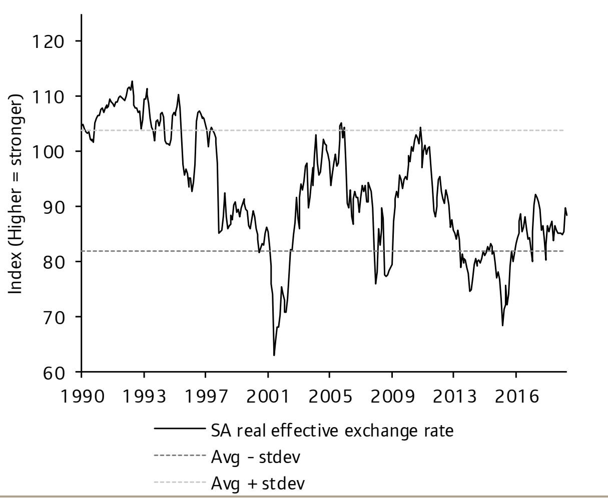
We estimate that the FY19/20 fiscal revenue forecasts are still achievable and, premised on the combination of spending cuts and tax hikes that we foresee, we expect the FY20/21 deficit to be around 6.6% of GDP rather than the MTBPS projection of 6.8%. Further bailouts of SOEs, in addition to the support already announced for Eskom and other SOEs, continue to pose a risk to the fiscal projections, as do the potential liabilities of the Road Accident Fund (RAF) and the elevated unpaid bills and accruals of provincial and local governments. These risks are counteracted by the potential gains from the spectrum auction scheduled for 1Q21, which we don't yet include in our forecasts and which we don't expect Treasury to include in its projections yet. It is difficult to predict when the gains from the improvements underway in SARS's capacity, which Treasury has repeatedly indicated could be sizeable, are likely to materialise. Judge Dennis Davis, who headed the Tax Review Commission, at the end of 2019 said that a "significant closure of the tax gap" is on the cards, which he "didn't think was possible".

We don't expect these consolidation steps to stave off a Moody's rating downgrade to junk. Encouragingly, SA's credit rating is still within the rating range estimated by the Moody's rating matrix. However, the jump in forecast government debt-GDP, even if policy steps lower the trajectory relative to the MTBPS forecasts, significantly worsened SA's metrics compared with peers. Furthermore, Moody's not only lowered its assessment of SA's fiscal stance in its latest assessment, it also lowered the assessment of the susceptibility to event risk. Moody's also flagged the unsustainable gap between SA's expected medium-term growth rate – which it now estimates at only 1 - 1.5% - and the real interest rate, which, in the absence of a primary budget surplus, means that government's debt won't stabilise. We thus see the odds as biased towards a downgrade by Moody's (also see Moody's: final warning and MTBPS: further thoughts). The risk of a downgrade by Fitch is also significant, with that rating placed on negative outlook last year — even before the disappointing October MTBPS. S&P might also downgrade SA's sovereign credit ratings in 2020 (see S&P: negative outlook on SA's worst rating).

Rand within fair range but vulnerable

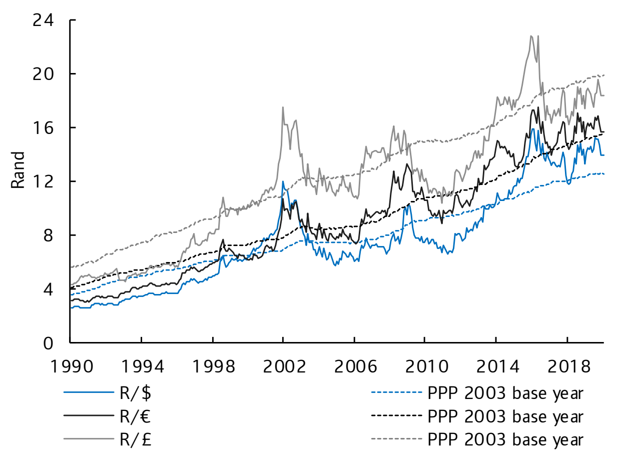
Assessments of the value of the rand differ across valuation metrics. Even purchasing power parity (PPP) assessments differ markedly across the major currencies – the rand seems to be strong relative to the pound, weak relative to the dollar and in line with its PPP estimate against the euro. We forecast the rand to be relatively stable against the dollar on average in 2020, apart from a downgrade-related spike, premised on the dollar weakness foreseen by our G10 strategist Steve Barrow. Against a stronger pound, though, the rand will likely lose more ground. We emphasise the real trade-weighted assessment, which arguably implies that the rand was on average reasonably valued in 2019.

Figure 24: Real trade-weighted rand implies rand is fairly to slightly overvalued



Source: SARB, Bloomberg, Standard Bank Research

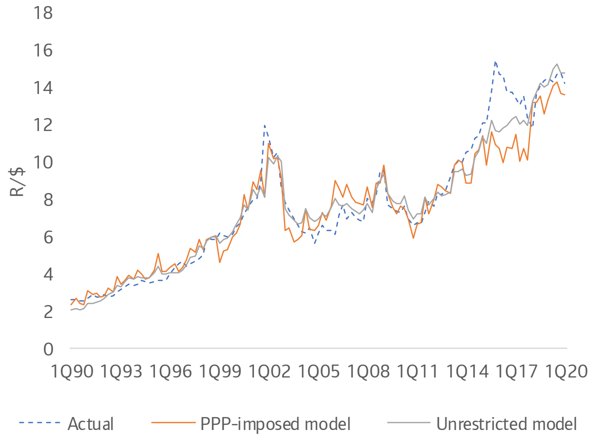
Figure 25: Rand weak vs USD PPP, around EUR PPP, strong vs GBP PPP



Source: Bloomberg, Standard Bank Research

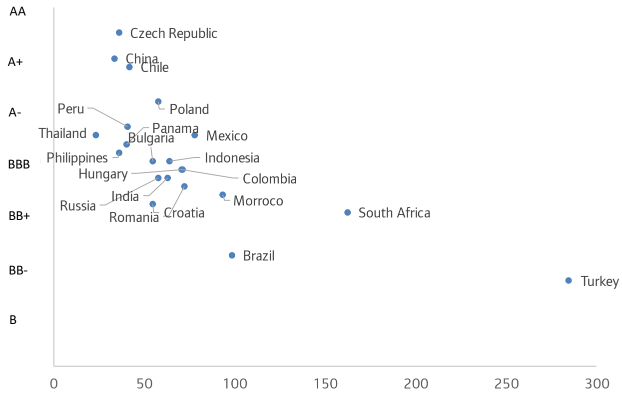
The rand is within the range of fair value estimates of our econometric models, which essentially compares the rand to the Australian dollar as a proxy for prevailing global commodity and currency markets, with appropriate adjustments for differences in the two economies' economic fundamentals. The rand's weakness relative to peers also seem reasonable given the weakness in SA fundamentals and when taking into account historical benchmarks. This is despite support from high real bond yields and elevated terms of trade.

Figure 26: Rand within fair value range estimated by econometric model



Source: Bloomberg, Standard Bank Research

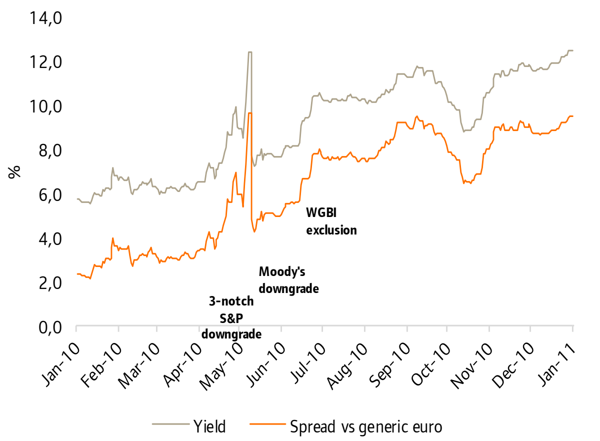
Figure 27: CDS vs sovereign credit ratings comparison suggests SA already priced like junk-rated country



Source: Bloomberg, Standard Bank Research

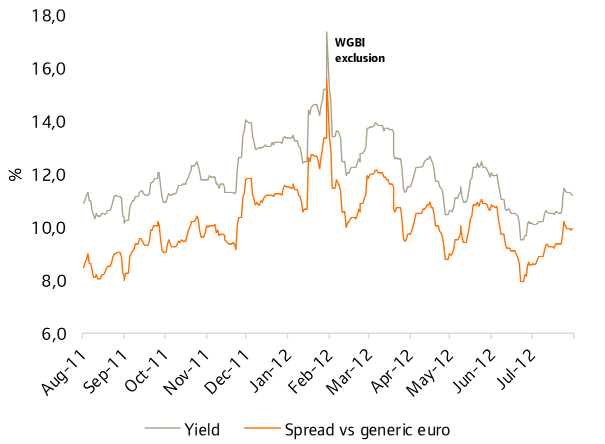
SA's expulsion from the WGBI, which will be triggered if Moody's downgrades SA, should only have a temporary impact on the currency and bond markets given the expected capital outflows that will follow. Sovereign credit ratings, according to our econometric analysis, do not (on average) influence the rand and local bonds beyond the underlying economic fundamentals that underpin them. Ultimately, the subsequent sustained levels depend on the trajectories of economic fundamentals and global market conditions. We pencil in a trend of modest nominal depreciation in the trade-weighted rand in the medium term from its 2019 average levels, with the real trade-weighted rand expected to essentially trend sideways.

Figure 28: Greek bond yields spiked when it lost its investment-grade status



Source: Bloomberg, Standard Bank Research

Figure 29: Portuguese bonds spiked when expelled from the WGBI



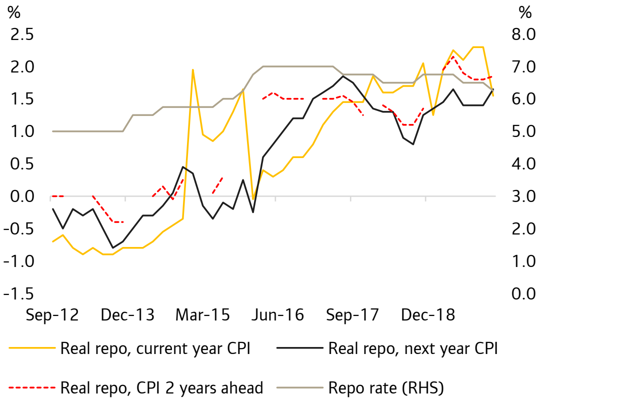
Source: Bloomberg, Standard Bank Research

Weak inflation may compel lower rates

We foresee only a marginal rise in inflation in 2020 after averaging less than the inflation-target mid-point in 2019. This is supported by low global inflation, weak domestic demand and the (expected) absence of sustainable rand weakness. Elevated agricultural grain prices should boost retail food inflation. However, despite unfavourable base effects and the below-average rainfall forecast for the upcoming maize planting season, these agricultural prices have remained reasonably tame (partly owing to rand strength) and there is limited pipeline pressure that still needs to filter through. For now, poor rainfall might underpin some culling, while the renewed outbreak of foot and mouth disease constrains exports, suppressing red meat prices in the near term (although these supply constraints will ultimately underpin upward price pressure). We thus expect a modest retail food inflation cycle in 2020, in addition to which we pencil in ongoing pressure from real electricity tariff increases, in line with the latest tariffs awarded by Nersa. We further assume normalisation of some of the categories that have recently been recording extremely low inflation, including the weighty rental inflation category, though we see the risks as definitively biased to the downside amid the demand weakness.

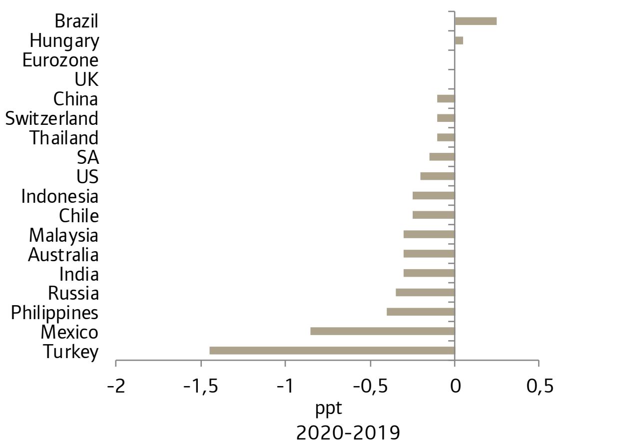
Not only are our inflation forecasts close to the mid-point of the inflation target and below the SARB's forecasts, but surveyed inflation expectations appear to be very well anchored inside the target range, while breakeven inflation is also endorsing the SARB's credibility in anchoring inflation around the middle of the target band. We thus concur with the money market's view that the SARB will cut rates by another 25bps this year.

Figure 30: Real rates still higher than SARB's recent interest rate cuts



Source: Bloomberg, Standard Bank Research

Figure 31: Policy rates generally expected to fall further in 2020

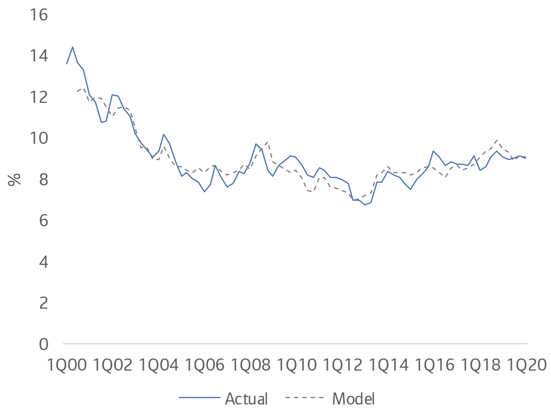


Source: Bloomberg, Standard Bank Research

Bonds cautious amid high risks

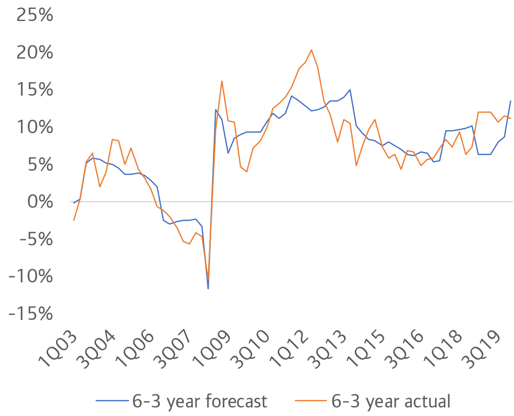
Our econometric model of the 10-year generic yield estimates that it is discounting a debt-GDP trajectory of around 77% (*ceteris paribus*, see Bond model: unpacking the drivers). In other words, bonds seem to adequately discount the weak fundamentals associated with the deterioration in SA's sovereign credit ratings as well as a sizeable risk premium. Local bonds, like the rand, might sell off in response to the WGBI expulsion, which could present a buying opportunity provided that government takes steps to restore fiscal sustainability, though we don't rule out the possibility that there is, from reasonably weak levels, no further bond weakness.

Figure 32: Econometric model of 10-year generic yield implies it discounts a debt-GDP trajectory around 77% or sizable risk premium if our 72% forecasts materialise



Source: Bloomberg, IRESS, Standard Bank Research

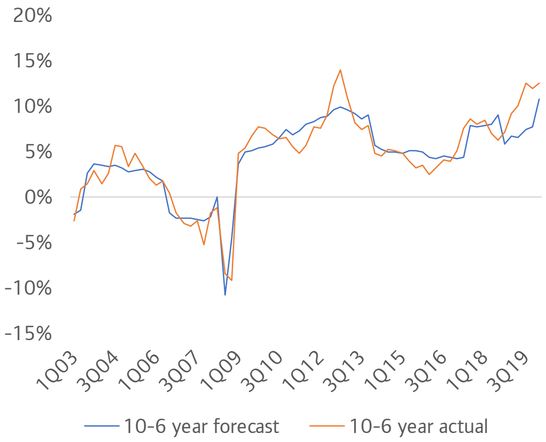
Figure 33: Adjusted 6-3 year yield spread[6] seems to be reasonable, discounting realistically weak fiscal trajectory



Source: Bloomberg, Standard Bank Research

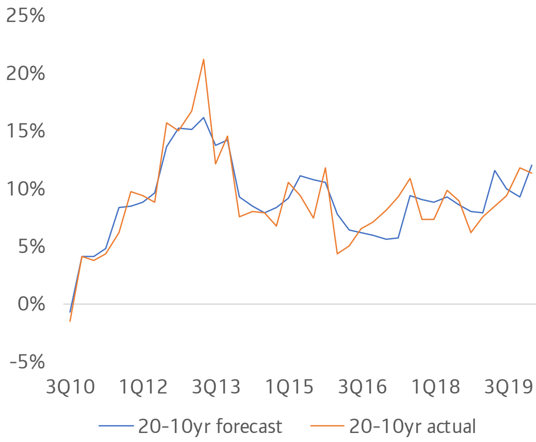
Following the sharp increase in local bond issuance in August 2019, government could theoretically delay increasing bond issuance after the 2020 Budget if it assumes that the pace of non-comp uptake persists and if its fiscal forecasts are similar to ours. However, we expect government's assumptions in this regard to be more conservative, as usual, in which case it could increase bond issuance by around R300 m per week, particularly given that funding requirements are not expected to decline in the future. While government only ruled out switch auctions in 2019/20, a resumption of these auctions is not really supported by the redemption profile, unless they are merely used to smooth increases in issuance, given that redemptions will rise in 2020 - 2021 but remain low relative to the subsequent (longer-term) trend.

Figure 34: Adjusted 10-6 year yield spread seems steep even for a severe fiscal scenario



Source: Treasury, Standard Bank Research

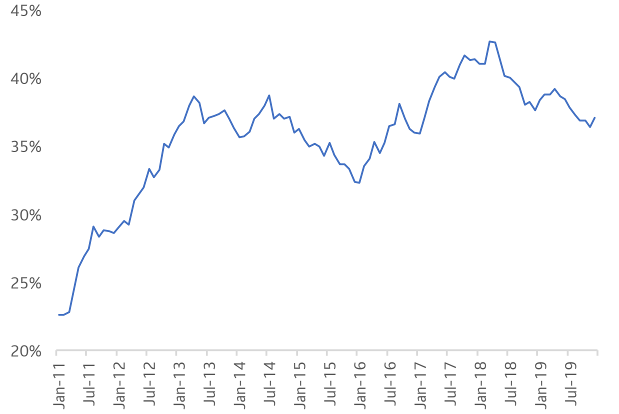
Figure 35: Adjusted 20-10 year spread flat, but 20-year steep vs shorter end once adjusted for 10-year steepness



Source: Treasury, Standard Bank Research

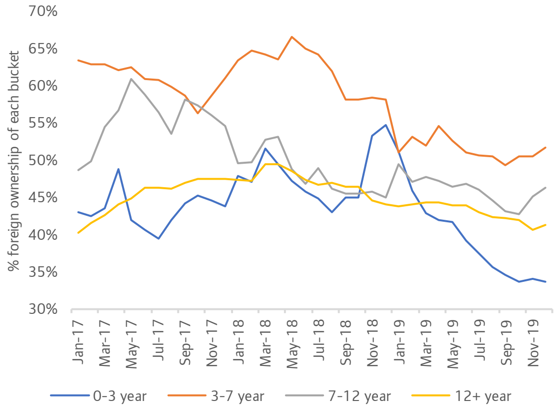
[6] Adjusted for the level of short-term rates.

Figure 36: Foreigners bought bonds in December, increasing their ownership proportion …



Source: Treasury, Standard Bank Research

Figure 37: …they dislike short-dated bonds



Source: Treasury, Standard Bank Research

Figure 38: Forecast summary

% avg	2019	2020	2021
Household consumption expenditure (HCE)	1.1	1.2	1.6
Gross fixed capital formation (GFCF)	-0.4	0.5	1.6
GDP	0.3	0.8	1.5
Current account (% of GDP)	-3.2	-3.2	-3.4
R/$ (avg)	14.43	14.68	14.79
R/$ (YE)	14.00	14.60	14.90
R/€ (avg)	16.16	16.99	18.11
R/£ (avg)	18.37	20.41	22.39
CPI (avg)	4.1	4.4	4.6
Repo rate (YE)	6.50	6.00	6.00
10-year generic bond (YE)	9.0	8.8	8.7

Source: Bloomberg, Standard Bank Research

Elna Moolman[#]

See:
https://ws15.standardbank.co.za/ResearchPortal/Report?YYY2162_FISRqWkWXsiVvZ2Df6d6RWf8LkxGxAFu2In+h7ataAnzcyZhBSp7l8gA9/oWomgu/xoilTm+eZxFlsNR4ivNUQ==&a=-1

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