KPMG cutting through complexity

MONITORING AFRICAN SOVEREIGN RISK

NKC independent economists

SOUTH AFRICA SNAPSHOT

2013 Quarter 4

Inflation – The consumer price index (CPI) increased by a smaller-than-expected 0.4% m-o-m during December, including higher indicators for transport and housing. From a regional perspective, the index was flat in the Western Cape and climbed 0.4% m-o-m in Gauteng. The CPI climbed by a smaller-than-expected 5.4% y-o-y from a reading of 5.3% y-o-y recorded in November. Headline inflation would be 0.6 percentage points lower were it not for the 7.8% y-o-y rise in administered prices, including 10% y-o-y more expensive petrol. Food cost just 3.5% y-o-y more, which says more about weakness in consumer spending than cost pressures on food prices.

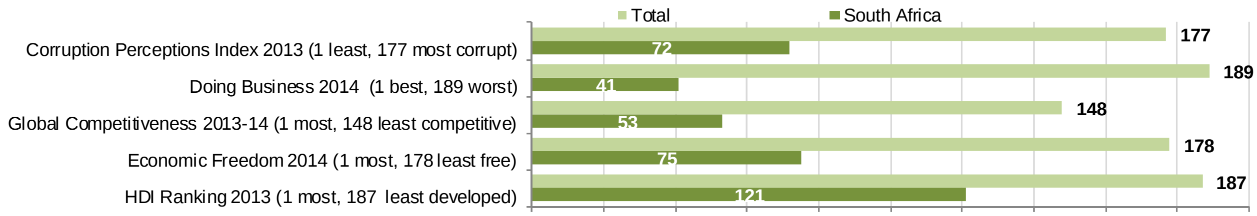
Growth – The South African economy expanded by only 0.7% q-o-q (seasonally adjusted and annualised) during Q3 of 2013 - its weakest performance in four years. Widespread strikes in the automotive industry caused the manufacturing sector to contract by 6.6% q-o-q. The economy was only 1.8% y-o-y larger during the third quarter and is estimated to have expanded by less than 2% during 2013.

National development plan – South Africa's National Development Plan (NDP) 2030 is the country's first long-term plan to help the economy create jobs and reduce poverty. The main goal of the scheme is to reduce the unemployment rate to 14% by 2020 and 6% by 2030, as well as reduce the level of inequality as measured by the Gini coefficient from 0.7 in 2009 to 0.6 by 2030. However, while the Presidency and Cabinet has officially backed the NDP, implementation of its ideas needs to be done on a ministerial level, where support varies.

OPPORTUNITIES	STRENGTHS
Immense scope for wind and solar power generation, though institutional factors need to be addressed.	Well-developed banking & financial sector - remained healthy throughout global financial crisis.
Growing trade and investment benefits from joining the BRIC (Brazil, Russia, India and China) grouping.	Well-managed fiscal & monetary policy over the past decade.
Growing middle class offering opportunities for the development of retail, entertainment and tourism sectors.	Large group of mega corporates, supporting fiscal revenues, while the country is not dependent on foreign aid.
Geographic location offers a gateway to Africa investment.	Diverse economy, with exports slowly moving away from minerals.

VULNERABILITIES	WHAT IS BEING DONE?
Rising social unrest and political tension as the government fails to live up to their voters' expectations.	Not much – electioneering in the run-up to this year's national polls is constraining policy formulation & implementation.
Low economic growth is not keeping pace with employment creation and poverty reduction needs.	The government is continually increasing its spending on public employment and social grants.
Water & electricity supply under increasing pressure.	State and parastatal expenditure on capacity expansion is on-going and has already shown some success.
The export-oriented mining & manufacturing sectors are challenged by an unpredictable exchange rate.	The central bank is active in the currency market from time to time in a bid to limit volatility, though results have been mixed in recent years.

MEGA TRENDS	
Population	Total: 52,982,000; Male: 25,823,300 (48.7%); Female: 27,158,700 (51.3%); Under 25: 25,658,071; Age 15-64: 27,323,920 (2013 est.)
Population growth rate (%)	1.34% (2013 est.)
Life expectancy at birth	Total population: 59.6 years; male: 57.7 years; female: 61.4 years (2013 est.)
HIV/AIDS	Total number of people living with HIV: 5.26 million; Total adult prevalence (15-49): 15.9%; HIV/AIDS orphans 2.1 million (2013 est.)
Adult literacy rate (age 15 and over can read and write)	Total population: 93%; male: 93.9%; female: 92.2% (2011)
Urbanisation	Urban population: 62.4% of total population (2012); Urban population growth: 1.9% (2012)
Population below $1.25 (PPP) poverty line	13.77% (2009 est.)
Unemployment rate	24.7% (2013 est.)
Employment (% of total)	Agriculture: 5.03%; Industry 23.28%; Services 71.67% (2013 est.)
Labour participation rate (% of total population ages 15+)	65% (2013 est.)
Business languages	SeSotho, SeTswana, SePedi, XiTsonga, XiVenda, isiNdebele, isiSwati
Telephone & Internet users	Main lines in use: 4.03 million; Mobile cellular: 68.39 million; Internet users: 21.72 million (2012)
Sources: CIA World Factbook, World Bank, Trading Economics, UNESCO, ITU, UNAIDS	



Source: NKC Research

Risk environment / Risk outlook

Sovereign Risk Ratings		
S&P	**Fitch**	**Moody's**
BBB/Negative	BBB/Stable	Baa1/Negative

Standard & Poor's (S&P) affirmed South Africa's "BBB" foreign currency rating on 20 December 2013 and retained its negative outlook on the assessment. It warned that the country's weak economic performance, external imbalances, and labour tensions could adversely impact the state's economic policy framework. Fitch Ratings reaffirmed South Africa's "BBB" rating on 19 December 2013 with a stable outlook. The company's analysts said soon after the Medium-Term Budget Policy Statement (MTBPS) that ratings could come under further pressure if the fiscal path laid out by this statement is not adhered to. Fitch still lists material slippage against the state's fiscal projections as a key factor that could result in a weaker credit rating, but has most recently made budget projections based on assumptions that the government will broadly stick to the fiscal budget deficit plans set out in the MTBPS. In turn, Moody's Investors Service said early in January 2014 that a slump in the rand is unlikely to negatively affect South Africa's sovereign risk rating because the government intentionally has a relatively small exposure to foreign-currency denominated debt. Likewise, the South African Reserve Bank's (SARB) determination not to intervene to try to affect the level of the rand means that volatility is not seen as a risk for foreign exchange reserves.

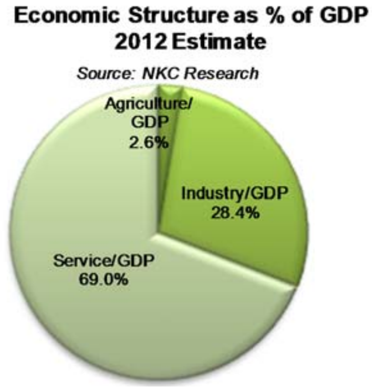
Infrastruc-ture	Diversity of the Economy	Banking Sector	Continuity of Economic Policy	GDP Growth	Key Balances	Foreign Investment	Socio-economic Develop-ment	Forex Reserves
Extensive, but deteriorating	Quite diverse	Dominated by SA firms	Debate & some uncertainty	Low	Twin deficits	Relatively strong	High in regional context	Healthy

Stock Market	Listed Companies	Liquidity	Market Cap	Dominant Sector	Daily Trading Volume
Johannesburg Stock Exchange (JSE)	397 primary listings (Source: Bloomberg)	Very liquid	$477bn (Source: Bloomberg)	Mining	$1bn
Capital Market	**Development**	**Liquidity**	**Maturity Range**	**Municipal Bonds**	**Corporate Bonds**
Yes	Advanced	Very liquid	91-day to 36-year	Yes	Yes

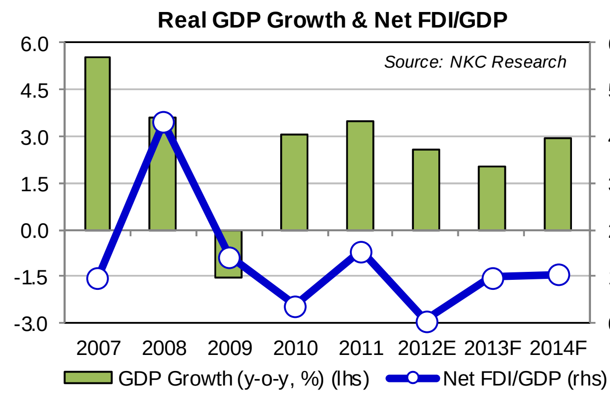
Macro-economic overview

South Africa has almost all the commodities essential for international competition except crude petroleum products and bauxite (which is used in the manufacturing of aluminium). However, the two-tiered nature of the economy continues to constrain its potential; one rivalling developed countries and the other with only the most basic infrastructure. The economy is productive and industrialised around urban nodes, but at the same time exhibits many characteristics associated with developing countries, including a division of labour between formal and informal sectors. Four out of five South Africans are from black African ancestry, with the remainder originating from Asia and Europe. South Africa has amongst the highest Gini coefficients in the world – indicating that income distribution in the country is among the most unevenly divided of all countries.

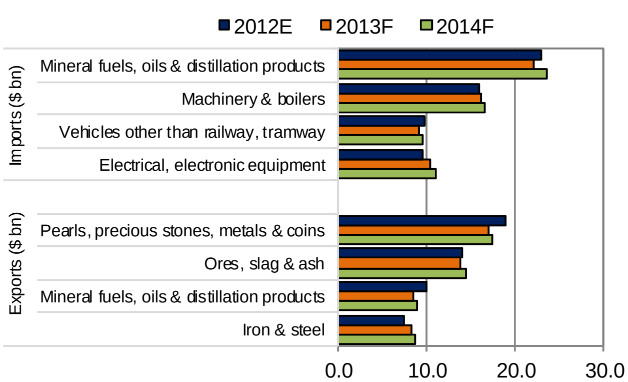
The big fiscal deficits over the past several years reaffirm the ruling party's goal of being a primary employment creator in the economy as opposed to facilitating a more conducive business environment in order to support private sector job creation. The South African economy is lagging behind the steady growth pace of many other African states, and local businesses argue that tough labour market conditions are amongst the reasons for their reluctance to employ more people. (Soon-to-be-revised national accounts could see Nigeria immediately eclipse South Africa as the continent's largest economy.) Another challenge to the private sector is the country's infrastructure constraints, which is also a key expenditure point in the state's goal of employment creation as a tool to reduce poverty and inequality.



South Africa's primary sector consists of a commercial mining sector, fisheries at the coast, forestry operations located in Mpumalanga, KwaZulu Natal, and the Eastern and Western Cape, and a farming sector that includes commercial (sometimes export-oriented) operations, as well as subsistence activities. The secondary sector includes electricity and water services monopolised by the state, manufacturing and heavy industrial installations in major cities, as well as a well-developed construction sector. The tertiary sector is comprised of a financial sector on par with some of the developed world's banking systems, ever-increasing general government services, extensive wholesale, retail, restaurant and hotel facilities compared to other African states, transport and communication operators that work across the continent, and diverse personal services.

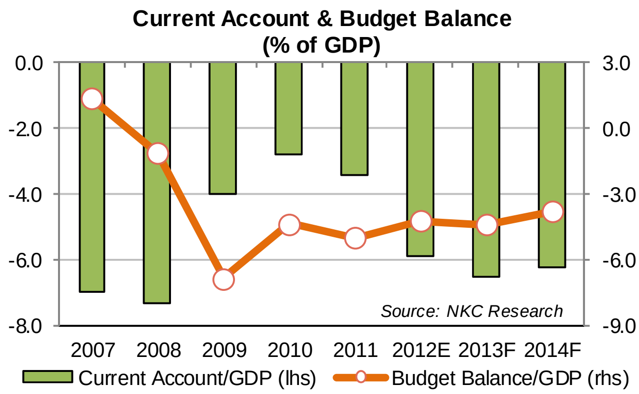


In the short term there are concerns about the financing of the current account deficit. *"South Africa, which has strong links with global financial markets, is particularly vulnerable to capital flow movements since debt-creating flows finance around 80% of the current account deficit,"* argued the World Bank's Africa Pulse publication of October 2013. According to the International Monetary Fund (IMF), during 2013-14 the value of capital flows will basically equal the size of the current account shortfall after exceeding the deficit over the past five years. Therefore, an obvious risk exists that any adverse developments towards the end of the year could result in inflows coming in smaller than the current account gap. South Africa has been grouped by Morgan Stanley along with Brazil, Indonesia, India and Turkey as the *"Fragile Five"* countries who appear very vulnerable to an easing in bond purchases by the US Federal Reserve. As large beneficiaries of the US central bank's easy money policy, these countries' current accounts could be hit if investors opt for less risk exposure.

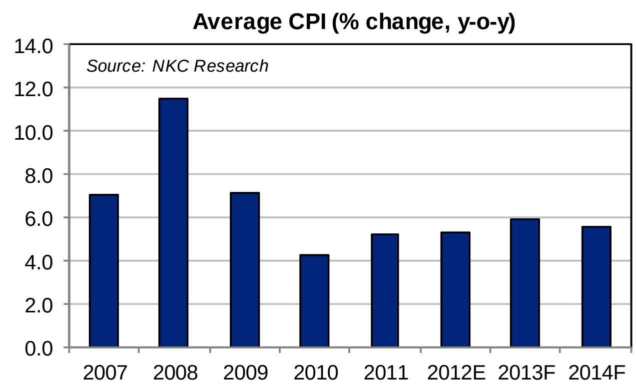


Main Imports: % share of total	2012E	2013F	2014F
Mineral fuels, oils & distillation products	22.41	22.53	22.50
Machinery & boilers	15.59	16.46	15.82
Vehicles other than railway, tramway	9.45	9.39	9.20
Electrical, electronic equipment	9.26	10.66	10.45
Main Exports: % share of total	**2012E**	**2013F**	**2014F**
Pearls, precious stones, metals & coins	20.33	19.88	18.59
Ores, slag & ash	14.98	16.12	15.51
Mineral fuels, oils & distillation products	10.70	9.88	9.51
Iron & steel	8.02	9.59	9.23

Exporters were last year expected to benefit from a weakening in the rand against the currencies of major trading partners. However, these prospects were stymied by weak economic conditions in the euro zone as well as domestic labour issues resulting in the slowdown of manufacturing and mining industries for certain periods over the past 12 months. Instead, the country's manufacturers have to contend with the impact of costlier import inputs. Statistics South Africa's (StatsSA) measurement for imported commodity prices increased 7.1% y-o-y during November 2013 of which more expensive mining and quarrying products (e.g. coal and metals) contributed 5.4 percentage points.



South Africa's current account deficit widened during Q3 of 2013 to the biggest shortfall in five years, increasing the economy's vulnerability to external shocks. The deficit expanded to 6.8% of GDP during the period from a revised 5.9% of GDP reading during the second quarter. The weak rand inflated import costs, while strikes in key industries and subdued global demand hurt exports during July – September. The second quarter's deficit was revised narrower from a previous 6.5% of GDP measurement following the South African Revenue Services' (SARS) recent inclusion of trade data with Southern African Customs Union (SACU) neighbours Botswana, Lesotho, Namibia and Swaziland, with which South Africa runs large trade surpluses. SARB officials indicated that excluding trade with SACU neighbours, the current account deficit in Q3 would have been wider than 7% of GDP. Still, the extent of South Africa's current account deficit remains a major cause for concern.



The SARB's Monetary Policy Committee (MPC) left interest rates unchanged after a three-day policy meeting during November. SARB Governor Gill Marcus said that with inflation still *"uncomfortably close"* to the upper end of central bank's 3% - 6% target range, there was no room for further monetary easing. The SARB marginally lowered its average inflation rate forecast for 2014 to 5.7% but warned that the depreciation of the rand posed increasingly upside risks to the outlook. A Bureau of Economic Research's (BER) survey shows that inflation is expected by business people, analysts and labour unions to average 6.1% during 2014 - our forecast is for a mean of 5.6%. Both the SARB and BER numbers indicate that there is no room to lower interest rates in spite of the South African economy losing its momentum during H2 of 2013.

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