

SUMMARY

- Political risk has steadily mounted over 2016 as a result of corruption scandals, political infighting, fears of a credit rating downgrade, and poor economic growth.
- Over 2017, President Jacob Zuma's room for manoeuvre will become increasingly restricted as a result of the fallout of the *State of Capture* report and political infighting with respected Finance Minister Pravin Gordhan.
- Although South Africa narrowly avoided a credit rating downgrade in December, a downgrade in June cannot be ruled out.
- The contentious nuclear deal, if it goes ahead, will bring significant financial risks to Eskom and the MoF.
- Leadership debates will dominate the second half of 2017, with the ANC Party conference looming. There is no front-runner at this stage.

Country	South Africa
Key Risks	Political instability
	Credit rating downgrade
	Economic risk
Forecast Horizon	1-3 years
AKE Political Risk Rating	Low to moderate
Notable Dates	2017 ANC leadership contest
	2019 general election

Background

A year is a long time in politics, and 2016 marked a number of watershed moments in South Africa's democratic history. Political risk has steadily mounted in a year that has been characterised by numerous corruption scandals, ministerial reshuffles, political infighting, fears of a credit rating downgrade, widespread student protests, a decision to withdraw from the International Criminal Court, and municipal elections, which led to the worst result in the history of the ruling African National Congress (ANC).

In December 2016 AKE undertook a research trip to South Africa to evaluate political risk in the country and assess the outlook for 2017. This report summarises findings from interviews with journalists, politicians, businessmen, academics and an international credit ratings agency. Overall, the report demonstrates that many of the trends evident in what was a tumultuous 2016 are set to continue as longstanding issues reach their resolution, all in the shadow of the December 2017 ANC National Conference where a successor to President Jacob Zuma will be chosen and a path forward will be forged. There is therefore a case for caution as well as optimism as 2017 progresses.

AKE would like to thank all interviewees for their time and insightful comments.

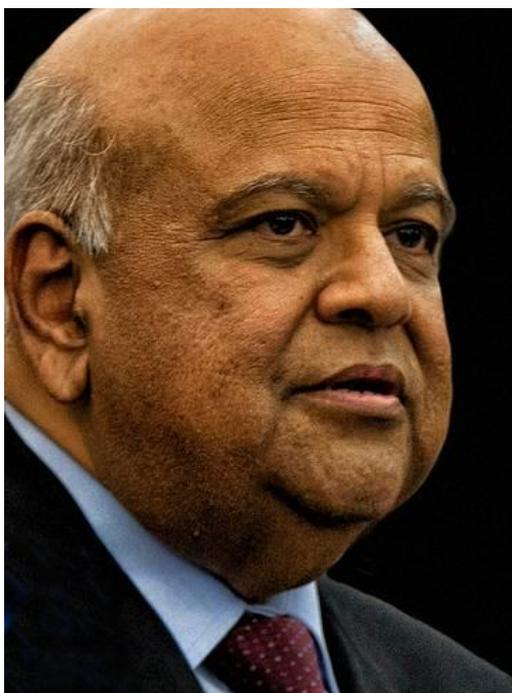
2016: A year of mounting political risk

If there was one word to describe South Africa in 2016, it would be 'captured'. That buzzword gained prominence following the release of a report by outgoing public protector Thuli Madonsela in November 2016 to describe the state of South Africa's political institutions. The report was a response to allegations that a wealthy Indian family, the Guptas, together with President Jacob Zuma, members of the ruling ANC and state-owned enterprises (SOEs), were implicated in a number of corruption scandals unprecedented in their audacity and reach. The year also saw the continued weakening of President Jacob Zuma through a number of incidents, which have undermined his previously 'untouchable' reputation that remained largely intact in spite of the 783 corruption charges that have been brought against him over the course of his political career.

The politically turbulent year began with the firing of respected Finance Minister Nhlanhla Nene in December 2015, based on spurious claims that he was to head the BRICS bank. This led to the position of finance minister changing hands three times in the course of one week. Markets

responded negatively to Zuma's choice of little-known backbencher David van Rooyen, with the rand tumbling to its lowest level against the dollar in over four years, as investor confidence spiralled amid fears of a credit rating downgrade to junk status. The strong reaction demonstrated that Zuma was unable to operate unconstrained, and he was forced to backtrack on his cabinet appointment by replacing van Rooyen with widely respected Pravin Gordhan.

The battle between the executive and treasury has dominated much of 2016, with Finance Minister Pravin Gordhan successfully surviving a number of attempts by Zuma and his faction of the ANC to implicate him in various scandals. This came to a head when Gordhan was issued with a court order after the National Prosecuting Authority determined that he had presided over a rogue spy-unit while head of the South African Revenue Service (SARS) and had wasted tax-payer money by reappointing a retired official as a consultant. Business, the opposition, the public and even members of the ANC came together to condemn what they considered to be trumped up charges. This demonstrated Zuma's increasingly limited room for manoeuvre.



South Africa' economic growth was 0.2 per cent in Q3 2016, falling slightly from the disappointing 0.5 per cent registered in Q2. The economy has come under strain this year as a result of both international and domestic factors. The global economic slowdown and low commodity prices have negatively impacted the South African economy, while drought and strikes in the mining sector have also weighed on growth. This disappointing growth has increased concerns of a recession, and the economy remains exposed to the prevailing political risk environment. More specifically, continued political infighting has reduced the government's ability to focus on and address economic challenges, while poor governance and patronage politics have the potential to dampen the economic outlook. However, Gordhan has shown incisive awareness of the required policy measures to revive growth but there remains a difficult to navigate trade-off between growth, debt and inflation. Significant structural issues remain over the longer term constraining the country's growth potential. Unemployment is at the highest level in decades, with some unofficial estimates putting youth unemployment as high as 70 per cent. Government exposure to SOEs is also concerning, amounting to 18 per cent of government liabilities.

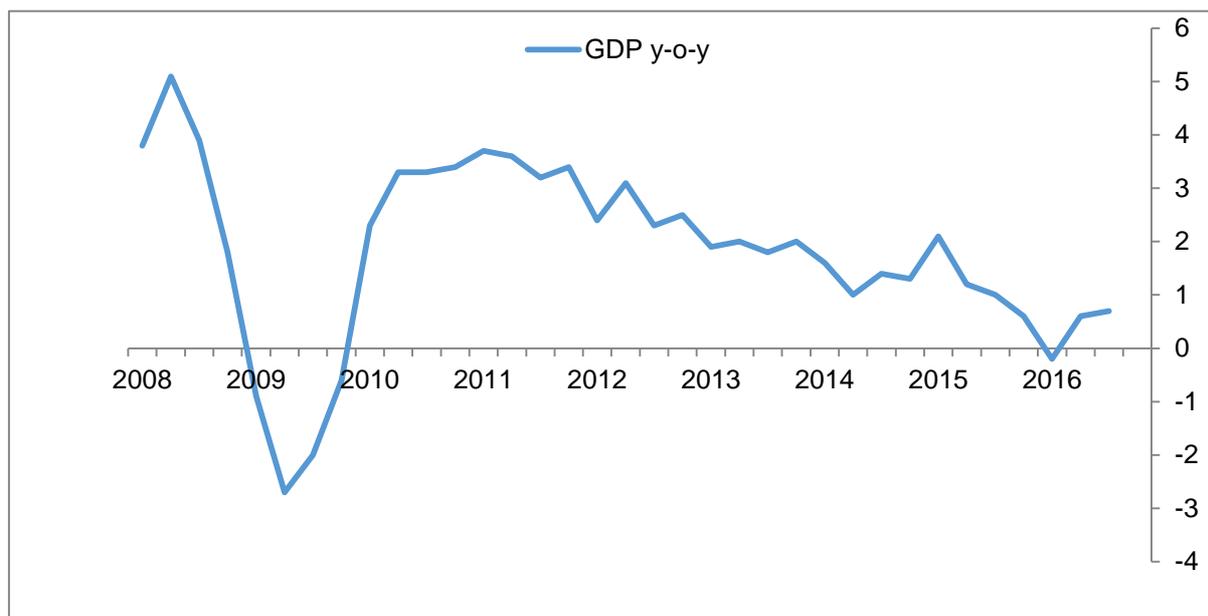


Figure 1: Annualised GDP growth

Source: stats.za

2016 was also characterised by a waning support for the ruling ANC as a public became increasingly frustrated by the lack of growth, inadequate service delivery of essential public goods and services, and political cronyism. This came to a head in August 2016, where the ANC suffered their largest defeat in any election since the end of apartheid in 1994. They lost major municipalities including Johannesburg, Tshwane (Pretoria) and Nelson Mandela Bay (Port Elizabeth), in addition to Cape Town, which had been previously taken in the municipal election. Opposition Democratic Alliance (DA) and radical populist Economic Freedom Fighters (EFF) found themselves in an odd political alliance, and their ideological differences could make the running of municipalities over the coming years a challenge. Their performance could significantly impact the result of the 2019 general elections, with the potential for ANC to lose more ground.

Ending the year as it started, a day before stepping down Public Protector Thuli Madonsela submitted the explosive *State of Capture* report as her parting gift. After repeated attempts on the part of Zuma to delay the publication of the report, it came out on 2 November 2016 to devastating effect. Its release also highlighted the strength and credibility of the country's institutions, highlighting their independence and effectiveness in the face of attempts by the executive to subvert and stymie processes. Through a careful examination of phone records together with testimonies of prominent politicians, *State of Capture* meticulously exposed a web of corruption between President Zuma and the wealthy Gupta family. The report also implicated members of the ANC and state-owned enterprises. The corruption was unprecedented in its scale and ambition, with the Guptas found to be behind the controversial sacking of Nene at the end of 2015, and influencing other ministerial and parastatal appointments. SOEs including South African Airlines and Eskom were also implicated, while the Guptas also secured lucrative and preferential government advertising contracts for their New Age newspaper. The findings have further tarnished President Zuma's reputation and intensify calls for his resignation, including from key factions within the ANC. Previous disagreements and political battles took place behind closed doors, and 2016 was the year that these took centre stage. A commission to fully investigating the findings will soon be set up, but it remains to be seen whether the embattled president will be able to successfully circumvent independent democratic practices during the investigation process.

Prospects for 2017

Political Risk Rating	3.1	Low to moderate
Economic Risk	3.6	Low to moderate
CEN	2.9	Low to moderate
Frustration of Process	2.9	Low to moderate
Political Stability	4	Moderate
Political Violence	2.25	Low to moderate

Figure 2: South Africa political risk rating

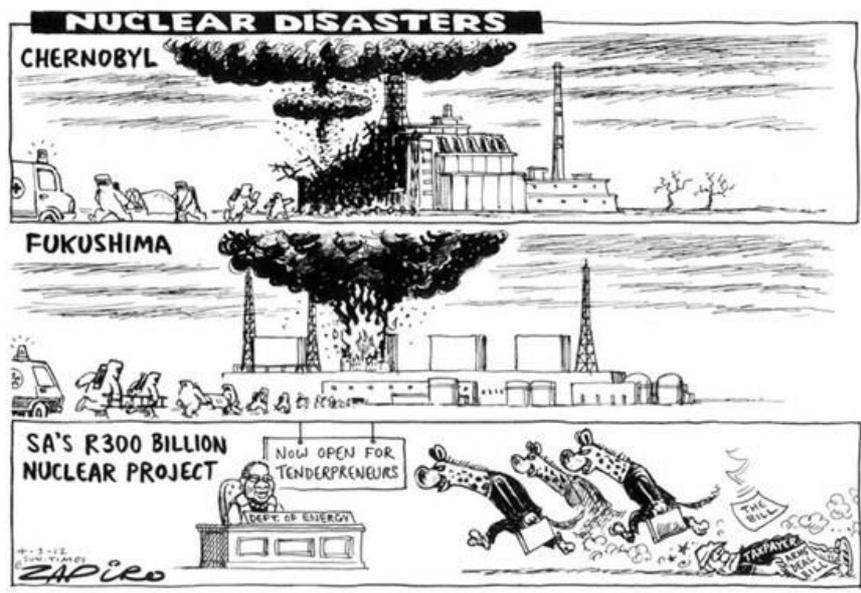
Source: AKE Global Intake 2

Many of 2016's trends are set to continue into 2017, as the issues exposed over 2016 reach their resolution, political infighting within the ANC likely intensifies and becomes increasingly public, and calls for President Jacob Zuma to step down mount. However, in many ways, with everything made transparent, a turning point has been reached and there is a window of opportunity that longstanding issues can be addressed, change implemented and a new political consensus formed. Nevertheless, much uncertainty will remain.



In this climate, Zuma is likely to face more criticism from the public, political opposition and within the ANC, including the ANC's National Executive Committee. While Zuma is likely to survive any no-confidence votes given the comfortable majority secured by the ANC, it is important to note that his reputation has been severely tarnished over the course of 2016. While many South Africans at the beginning of the year believed Zuma's reputation to be impervious to a swathe of negative stories, the events of the year have demonstrated this not to be the case, and increasingly restricted his room for manoeuvre. For instance, Zuma's failure to get his way when it comes to ministerial appointments, particularly that of finance minister, means that it is unlikely that he will be successful if he tries again. This is good news for the business community and markets as it means that the risk of esteemed Finance Minister Pravin Gordhan leaving office due to political wrangling by Zuma is low alleviating concerns of a credit rating downgrade over the short term, and reducing political uncertainty from its current peak. The embattled president marches on, but his days are numbered and capacity for autonomous policy making is restricted.

A real test of Zuma's mettle will be his ability to push forward an extremely contentious nuclear deal, which would be the most expensive tender in the country's history. The deal will be funded by state-owned power utility, Eskom, which also saw its CEO step down earlier this year as a result of his implication in the state capture corruption scandals. If the deal were to go ahead, there would be a significant impact upon Eskom's balance sheet and given the government also has significant exposure to Eskom, the impact could be wide-ranging and damaging. Meanwhile, questions of lack of transparency in the procurement process and Russian involvement have served to further complicate matters.



However, one remaining constant is South Africa’s strong and effective democratic institutions, particularly its judicial system. In this environment, despite heightened political instability, the risk of government expropriation of assets or license cancellation will remain low, with a rigorous and transparent process and fair compensation awarded in the rare event of this occurring. Civil society groups also remain active, further testament to the country’s vibrant democratic culture.

The results of the August 2016 municipal elections marked a watershed moment in South African politics, with the emergence of a credible opposition and the beginnings of a multi-party system. Both a middle class and ‘born free’ generation have become increasingly fed up with the ANC’s inability to improve living standards, secure economic growth and bring development to the majority following the end of apartheid, as well as what they considered political cronyism, causing them to either not vote or to defect to the Democratic Alliance (DA) or the Economic Freedom Fighters (EFF). While the ANC are likely to retain power for the foreseeable future, following the results of the election, there are increasing murmurs of the unthinkable happening in either 2019 or 2024. The rising prominence of the radical Economic Freedom Fighters (EFF), with its firebrand leader Julius Malema, has also been the source of much concern for investors, particularly given the contentious issue of land reform and following the result of the August 2016 municipal election which saw the party become kingmaker in the country’s most economically significant municipalities. While the party will continue to attract votes from the young, poor and unemployed, their current ability to influence policymaking, particularly with regards to the economy remains extremely limited.

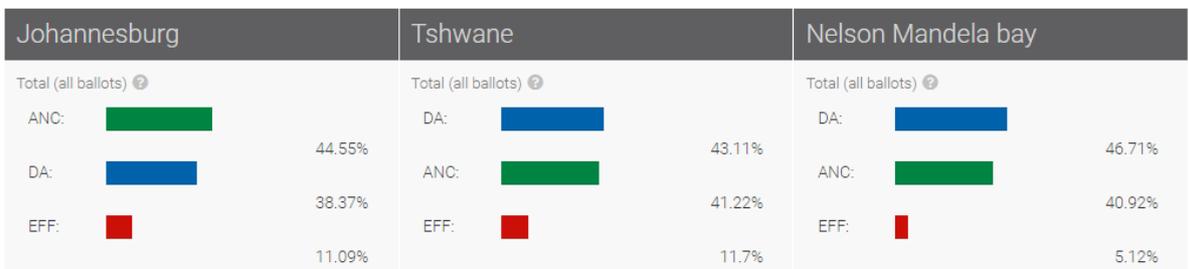


Figure 3: Vote share in Johannesburg, Tshwane and Nelson Mandela bay in August 2016 municipal elections
 Source: ENCA.com

The December 2017 ANC National Conference in which Jacob Zuma's successor as the party's leader, and in all likelihood the next president of South Africa, will be appointed will likely shape political debates and decision making throughout the year. At the moment, the leadership race remains hotly contested. In recent months, unions and prominent ANC figures have backed Deputy President Cyril Ramaphosa as their choice. Markets and the business community will be expected to react favourably if Ramaphosa were to gain the presidency. A former trade union leader whose reputation is enhanced due to his role in the struggle against apartheid, he is also one of the country's most successful businessmen, having sat on the boards of South Africa's largest companies. Yet his reputation has been significantly dented over his role in the 2012 Marikana massacre, in which at least 40 striking mine workers were shot dead by police, at the time he was a board member of the mine's operator Lonmin. A difficult two-year transition period, which sees Zuma as president and Ramaphosa as ANC leader, could bring with it deadlock in policymaking. The other contender for leadership is Nkosazana Dlamini-Zuma, Jacob Zuma's ex-wife and Chair of the African Union Commission, who has also served as Minister for Foreign Affairs and Minister of Home Affairs in the ANC prior to taking up the position. She has also gained the support of senior ANC figures – including Zuma himself, and the party's women's league. Should Dlamini-Zuma win the leadership, doubts will remain over her ability to put an end to the ANC's patronage politics, which proved debilitating throughout 2016.

Sectors to watch

Finance: South Africa's banking sector remains strong, and is effectively regulated enjoying good relations with the Reserve Bank and Treasury. Indeed, the finance sector has recorded positive growth every quarter since Q4 2010. The banking sector has been able to avoid falling over despite global economic crises, due to strict credit criteria and relatively strong liquidity. However, banks have not been shielded from this year's political developments. In August 2016, the country's largest fixed income manager, Futuregrowth Asset Management, stopped lending to SOEs stating concerns over their management, government infighting and threats to the independence of the finance ministry. More recently, in December 2016 Standard Bank issued an affidavit asking courts for protection against executive interference – specifically in connection to President Zuma calling for banks which stopped lending to the Gupta family to be investigated. The outlook for the banking sector over 2017 remains bright, and will continue to improve in line with modest economic growth, further facilitated by digital transformation.

Telecoms: South Africa's telecoms sector is international in its reach, and will benefit from increased mobile phone use across the continent, with Africa projected to have 1 billion mobile phone subscribers by the end 2016. As costs for mobile phones decrease, this number is set to rise further, representing a captive market that telecommunications companies will jockey for control over. In this setting, merger and acquisition activity cannot be ruled out. Current trends also highlight the increasing popularity of mobile data as the transition to 4G continues and the government continues its support for internet connectivity projects – with growth rates expected to reach over 25 per cent in the next five years. Use of associated mobile video content has also formed an extremely profitable income source. Ride-hailing apps and money-transferring services have all gained prominence in Africa over recent years, and this trend is set to continue.

Retail: The retail landscape in South Africa is dominated by local brands, including Woolworths, Pick and Pay and Mr Price, with strong brand loyalty. However, in recent years international brands have started entering the market opening a number of flagship stores in major cities signalling an active and competitive market going forward. In line with muted economic growth over 2016, consumer demand has been weak. Prospects for 2017 are better, in line with an economic recovery and growing affluent middle class. Yet, food price inflation will also weigh on consumer spending. More and more shopping centres are popping up in major cities, while digital transformation will also further boost the retail sector's profitability, with the underdeveloped online shopping market expected to be a source of significant revenue generation for retailers.

Mining: South Africa's mining sector has historically been the key source of growth. Today the sector accounts for 8 per cent of GDP, and is the country's second largest employer. However, as a result of low commodity prices and muted global demand, the mining sector has come under strain over 2016. As low commodity prices persist, this trend is set to continue, although increasing gold prices are a cause for optimism, as is the end of damaging strikes of platinum workers now that a settlement has been reached. AKE's in-country sources attested that the heavy unionisation of the sector will also result in the persistence of low levels of mechanisation, with high levels of inefficiency as a result. While there have been some calls for nationalisation in recent years, it is unlikely that government policy will alter in line with popular sentiment.

SOEs: SOEs are an important sector in the South African economy, not least as they form a substantial part of government liabilities and employ a large proportion of the workforce. SOEs have not been spared from the Gupta corruption scandal, with many including the South African Broadcasting Corporation (SABC), South African Airlines (SAA) and Eskom considered 'captured' institutions. Some progress has been made to implement transparency within the companies. For example, new board appointments in the loss-making airline mark a positive step. Following involvement in corruption scandals, Eskom CEO Brian Molefe announced his resignation in November 2016. Looking ahead, Eskom's nuclear deal, slowing growth and muted demand for electricity will all prove important tests for the state-owned power utility, with increased risk that a government bailout will be required. For further information, please refer to AKE's special report on Eskom and the nuclear deal.