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PRESS COVERAGE

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SA country outlook - inflation to peak above 8% in 2014

Strengths

• The economy of South Africa is the largest in Africa, accounting for 24% of the continent's GDP in terms of PPP, and is ranked as an upper-middle income economy by the world bank.

• The country has abundant natural resources, well developed financial, legal and transport sectors, a stock exchange ranked amongst the top 20 in the world, as well as a modern infrastructure supporting efficient distribution of goods throughout the Southern African region.

Weaknesses

• South Africa suffers from a relatively heavy regulation burden when compared to most developed countries.

• Increasing costs for corporates with rising wages.

• Poverty, inequalities sources of social risk mixed with high unemployment and shortage of qualified labour.

Economic growth

Third quarter economic growth rose to 3,8% q-o-q. Against a backdrop of a wide current account deficit and slowing foreign capital flows, indicators of domestic economic activity reflect that consumers remain under pressure. Coface expects this to intensify over the coming months as the recent currency weakness feeds into higher inflation. Not only will the higher inflation rate weigh on disposable income growth, it will also push the SARB to hike interest rates further. Until we've seen a meaningful improvement in the current account deficit, risks are that the rand may get pulled along in a major emerging market sell-off which will force the SARB to hike interest rates aggressively to assist in a sharp rebalancing of the economy.

The lagged impact of recent exchange rate weakness and the adjustment in the near-term exchange rate forecast has pushed the inflation forecast up. Coface now sees inflation peaking at 6,5% y/y in June before trending back towards 6% by the end of the year. Coface then expects inflation to trend close to the top end of the inflation target band throughout 2015.

Both food and fuel prices will continue to put upward pressure on the inflation rate for the next few months. Exchange rate and oil price forecasts suggests that the petrol price will be hiked by another 30c/l in April. Food price inflation should push higher and peak above 8% y/y by the end of the year. Most major sectors fared better over the quarter, albeit in some

cases only marginally, but the biggest boost came from higher value added in the mining, manufacturing and agriculture.

Economic conditions deteriorated in early 2014 given the strikes in the platinum mining industry, the unexpected hike in interest rates in January and rising inflationary pressures due to a weaker rand. However, economic activity is expected to pick up as the year progresses.

The mining, manufacturing and construction sectors should benefit from a combination of strong global growth, a weaker rand and increased infrastructure spending by the public sector. Household spending is expected to moderate as wage growth in public sector slows, the cost of living increases due to the weaker rand and indebted consumers adjust to rising interest rates. Overall, Coface expects GDP to grow by a moderate 2,6% in 2014 as a whole.

Economy by sector

Growth in annual mining production accelerated to 12,0% in December, from 5,2% in November. The stronger growth was mainly as a result of increased iron ore production, which added 5,8 percentage points to the annual increase. On a monthly basis, seasonally adjusted mining production increased by 6,2% after a 3,2% decline in November. Over the fourth quarter growth in mining production increased 4,3% q-o-q from a 0,1% decline previously.

Mining output has been fairly volatile, mainly due to labour unrest in the sector. Continued labour unrest in some parts of the sector, infrastructure constraints and lower growth in China will probably continue to have a negative impact on production. Mining figures are volatile and therefore will have little influence on policy decisions in the short term. Coface expects that the Reserve Bank will raise rates by 50 basis points at the next Monetary Policy Committee meeting and then keep rates steady until the second half of 2015.

Manufacturing production surprised on the upside, rising by a seasonally adjusted 0,4% m-o-m in December, pushing the annual growth rate up to 2,5%, better than a weak 0,3% in November and the 1,4% increase expected on average by the markets. The stronger annual growth was mainly due to higher output of food and beverages off a very low base in December 2012. In 2013 manufacturing output rose by a modest 1,3%, down from 2,1% in 2012.

Output by the manufacturing sector is likely to improve moderately in 2014. A weaker rand and some acceleration in global demand are expected to encourage higher production levels, but the upside will remain constrained by uncertain and insufficient power supply, other infrastructure constraints and rising production costs. The low base in the second half of 2013 due to strike activity will also boost annual comparisons.

The moderate pace set towards the end of 2013 is expected to continue into the first half of this year, with the risk still tilted to the downside given significant global challenges, weak domestic confidence, increasingly volatile financial markets, the higher cost of credit and the upcoming local elections.

Encouragingly, there has at least been some pause to the rand's slide, although it remains vulnerable given both the large current account and fiscal deficits and the change in global investor sentiment towards emerging markets. The Monetary Policy Committee (MPC) will probably remain hawkish until either the rand recovers lost ground or the economy weakens sharply.

Annual growth in retail sales was stronger than expected at 3,5% in December, against the market forecast of 2,7%, but the growth rate slowed from the 4,4% recovered in November. On a monthly basis, sales rose by a seasonally adjusted 1,4%, pushing sales for the last quarter of 2013 up by 3,1% compared with the same period in 2012. Subdued consumer spending is expected to prevail in 2014 as the poor economic outlook, high existing debt levels, tight lending standards, high cost of credit and the weak job market weighs heavily on the household confidence and expenditure.

Global investors have lost confidence in emerging markets. Fed tapering generated a concern about a slowdown or even reversal of capital flows. This was then followed by a confluence of idiosyncratic factors: political troubles in Turkey and Ukraine and currency devaluations in Argentina and Venezuela. Currencies have consequently depreciated sharply across a wide swath of the emerging market universe and losses are generating even more losses as confidence drops and as troubled emerging market currencies trade off each other.

Authorities in the emerging market world have responded with currency intervention and rate hikes. Turkey has led the way: after intervention failed to stem the tide in the lira, the central bank hiked rates by 450+bp and threatened that further action would be forthcoming if needed. Russia, meanwhile said that they would defend the rouble at all costs, effectively promising unlimited intervention at the top end of their target band.

Foreign Trade

The trade balance, including trade with Botswana, Lesotho, Namibia and Swaziland (BLNS), turned to a large R17,1-billion deficit from a R2,6-billion surplus in December, against the market consensus of a R8,5-billion deficit and Coface's forecast of a R13,6-billion deficit. Exports increased by 0,1% m-o-m to R77,7-billion, while imports rose by 26,3% to R94,7-billion. Some improvement in the trade balance is expected in 2014 due to the weaker rand, some recovery in traditional trading partners and slow domestic demand.

However, supply disruptions in key export sectors, mainly manufacturing and mining, would erode some of the benefit of the weaker rand. These figures are unlikely to have much impact on either the rand or policy in the short term. The MPC raised the repo rate in January, prompted by the weaker rand and the risk of high inflation for an extended period.

The Achilles heel for the rand is the current account deficit. This is the number that really makes it part of the Fragile 5 club. And it is the deficit that makes the rand so reliant on attracting enough capital inflows. As such, and risks will reduce if and when the current account contracts.

This year should see a substantial improvement on this front, as the weak rand helps exports and slows imports, while the rate hike should further impact on imports, even as the exports get boosted by the improvement in the global economy. Global investors have lost confidence in emerging markets.

Inflation

Annual consumer inflation surprised to the downside in October, coming in at 5,5% from 6,0% in September and below the market's expectation of 5,7%. Inflation was generally expected to slow down in October owing to a 19 cents per litre decline in the petrol price over the period, but other categories such as food also increased at much slower rates.

The biggest contributors to the annual inflation number were housing and utilities (1,3 percentage points), miscellaneous goods and services (1,1 percentage points) and transport (1,0 percentage point).

On a monthly basis inflation increased by 0,2%. Equal contributions by the food and non-alcoholic beverages category and the residual item were responsible for the rise. Within the food and non-alcoholic beverages category, food prices were up 0,9% m-o-m and non-alcoholic beverages were up 0,3%. Within food, monthly price decreases were recorded for oils and fats, fruit and sugar, sweets and desserts. Price increases were recorded for breads and cereals, meat, fish, dairy products, vegetables and other food. Core inflation (inflation excluding food, non-alcoholic beverages, fuel and energy) increased 0,2% over the month. CPI for services increased 0,1% over the month.

Financial system

In the most recent Doing Business report, South Africa is ranked 39 out of 185 countries in terms of ease of doing business. This ranking is up four positions from last year. In some areas, the country's ranking has either remain unchanged, South Africa is still ranked as number one for ease of getting credit.

Labour force

The unemployment rate edged down to 24,1% in the fourth quarter of 2013 from 24,5% in the previous quarter, reflecting mainly a strong increase in informal sector jobs. The labour force increased by 91 000 to 20-million, while the number of unemployed people fell by 50 000 to 4,83-million. Informal non?agricultural sector jobs rose by 123 000 over the quarter, while formal sector non?agricultural jobs increased by 64 000.

The agricultural sector and private households shed 27 000 and 20 000 jobs respectively over the quarter. The unemployment rate is unlikely to be reduced significantly in the short term given weak domestic demand, rising input costs, labour disputes, significant infrastructure constraints and other regulatory issues in some of the key sectors. Figures suggest that the weak economy is still struggling to reduce the unemployment rate significantly.

The growth outlook is still fragile. At the same time, recent other indicators suggest that inflation is still contained, but the outlook has deteriorated due to the weaker rand. In order to contain the inflationary pressures, we anticipate that the Reserve Bank will raise rates once more in March before keeping them on hold well into 2015.