

Comment

Reshuffle brings downside risks to the fore

Introduction

Macro outlook

Conclusion

Introduction

As widely speculated over the past week and indeed for months, President Jacob Zuma announced a broad-based cabinet reshuffle late on Thursday evening. From a financial market and real economy perspective, the key changes are at the Finance and Energy Ministries. Finance Minister Pravin Gordhan and his deputy Mcebisi Jonas were fired and replaced by former Home Affairs Minister Malusi Gigaba and ANC MP Sifiso Buthelezi respectively.

Tina Joemat-Peterson was replaced as energy minister by ANC MP and Zuma loyalist Mmamoloko Kubayi. In recent years, Kubayi was part of the ad-hoc committee that looked into President Zuma's Nkandla debacle. While there were a host of other personnel changes, it is hard not to conclude that President Zuma's ultimate aim was to dilute the Treasury and Energy Ministries and put in place individuals that will be more receptive to an agenda of loosening the purse strings and going ahead with projects that are likely to benefit only a few. This, for example, may include agreement to forge ahead with a large-scale nuclear project. Broadly defined, the announced changes support the state-capture narrative that has increasingly been associated with the President and the Gupta family.

The immediate economic implications of the reshuffle are undoubtedly negative. Indeed, after already weakening earlier in the week, the rand exchange rate lost further ground to softer than R13.50/\$ this morning. Bear in mind that the rand traded around R12.40/\$ a week ago. Of concern from a fiscal point of view, domestic bonds sold off with the yield on the R186 government bond starting this morning's trading session 45bps higher at 8.95%. Of interest is that the rand has not weakened even more aggressively. This may be due to financial markets already, at least partly, discounting a negative reshuffle. Financial market participants have also expressed the view that President Zuma has, as was the case with Nenegate in December 2015, gone too far and that a major backlash will be forthcoming. Finally, a conducive global environment which is currently supportive of emerging markets may also explain why the currency reaction has not been even more severe.

In the absence of a backlash, significantly poorer macro outlook

The SA Reserve Bank (SARB) hinted at the implications of a further deterioration in the domestic political environment in the March MPC statement. The statement referred to the potential that the rand could overshoot on the weaker side. This would have adverse implications for the inflation outlook and argues against an interest rate reduction anytime soon. The political environment deteriorated sharply overnight

31 March 2017

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with the very real potential for the rand to lose further significant ground. In such a scenario, the MPC may be forced into continuing with the rate-hiking cycle.

While it is early days and there are numerous caveats, the cabinet reshuffle has the potential to set in motion a sequence of adverse developments. These include:

- The likelihood that S&P Global (and Fitch for that matter) could move swiftly to downgrade SA's **sovereign credit rating** to junk status. Moody's are sure to follow, and may in fact be the first agency to move on the rating in early April, but they still rate SA two notches above junk. It is not clear that they will downgrade the rating by two notches, but it is possible. In mid-2016, political turmoil in Turkey saw S&P immediately downgrade the country, while Moody's followed a couple of days later. It has to be emphasised that in Turkey's case we were dealing with an attempted coup. However, it could be argued that what the reshuffle may imply for future SA economic performance, i.e. a weaker GDP growth outlook and looser fiscal policy, would be sufficient to nudge the agencies towards an immediate downgrade. The caveat is that they may want to take some time in order to assess the extent of any backlash and the broader economic implications. *As outlined in our **April** and **October** Economic Outlook publications, a credit rating downgrade(s) to junk status will have a number of negative consequences, including foreign capital outflows, higher interest costs and a weaker rand exchange rate.*
- A further dent to already fragile **business** (and potentially also consumer) **confidence**. In the absence of a scenario where President Zuma is recalled from office swiftly, which could help to jolt business confidence higher, sentiment may decline even further from already depressed levels. *Were this to occur, the outlook for **private sector fixed investment** will be even worse than our current forecast.*
- A sustained **GDP growth underperformance** and possible recession. An environment of even lower confidence and investment, along with currency-induced inflationary pressures, rating downgrades and subsequent further interest rate hikes, suggest that **GDP growth** will be softer than our current (already subpar) baseline forecast in 2017-18, but also over the medium-term. *Softer GDP growth, along with a loosening of the budget purse strings (more spending) going forward, will contribute to higher budget deficits and overall government debt levels. This may result in a series of credit rating downgrades.*

Conclusion

These negative outcomes are not inevitable. For this reason, we have held back from updating the forecast numbers in the wake of Thursday's dramatic events. In the next couple of days, we will be watching any commentary or action from the credit rating agencies. Domestically, a key trigger for a more positive scenario than outlined above will be signs of moves that could result in President Zuma's recall. This could set in motion a more favourable medium-term outcome than our current baseline forecast assumes. However, at this early stage, our judgement is that the downside risks to the domestic economy have increased notably over the past 24 hours.

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