Major Country Risk Developments
August 2021

By Byron Shoulton

Overview

Sentiments have changed regarding wearing masks for the foreseeable future with the spread of Covid-19 Delta variant triggering awareness that the pandemic is not yet behind us. Still, the global economy is expected to strengthen over the coming months as activity in Europe begins to catch up with the U.S. and China. However, the spread of the more contagious Delta variant is causing forecasters to re-examine the global economic outlook. In developing countries where there has been limited access to vaccines, the IMF has warned that while global growth of 6% is still in the cards for 2021, new strains of the virus have made the economic outlook more uncertain and uneven. Vaccine access has emerged as the principal fault line along which the global recovery splits into two blocs. Some countries can look forward to further normalization of activities during 2021, but others continue to face resurgent infections and rising death tolls. The consensus is that even countries on the recovery track should not become complacent as the recovery is not assured even where infections are currently very low – so long as the virus continues to circulate and mutate elsewhere.

Surveys of businesses from across Europe recorded the strongest increase in economic activity over the last quarter- for more than two decades. That suggests the continent is set for the kind of growth already being experienced in the U.S. and China. But there are clouds on the horizon, with setbacks in Australia, India and other parts of Asia serving as a reminder that the pace of global economic recovery still depends on the course of the pandemic, which can be slowed by surges in infections as new variants emerge.

The IMF cut 0.4 percentage points off its growth forecast for emerging and developing economies in 2021, to 6.3%. The gloomier outlook is expected to be worse in south-east Asia, particularly India. By contrast, the forecast for advanced economies output growth was raised by 0.5 percentage points to 5.6%, with notable upgrades for the U.S., UK, Canada and Italy. Growth outlook for France and Germany remain unchanged while expectations for Spain and Japan were downgraded. We continue to face a situation where the pandemic is creating havoc around the world. With the Delta variant quickly becoming the dominant strain, the economic impact on wealthier nations is hard to determine. While cases are increasing, the number of hospitalizations and deaths appear to be muted. The immediate task is to see if the spike in new cases will affect spending patterns, change travel plans or hit overall confidence. So far, that is not yet clear. The varied pace of infections and vaccination programs, coupled with the ebb and flow of government restrictions, means that the recovery has and will continue to proceed at different paces in different parts of the world.

One significant risk is rising inflation. The consequence of the strong global recovery has been a faster rise in prices, which has prompted some central banks to raise their key interest rates. The Bank of Russia raised rates for the fourth time since March, lifting its key rate to 6.5% from 5.5% and warning that further moves are likely.

While the world's leading central banks expect the pace of price growth to peak later this year and then ebb, the IMF has warned that inflation could turn out to be more persistent than was earlier anticipated. There is a risk that this could prompt a more aggressive normalization of central bank policy, which would hit emerging and developing economies particularly hard. A double hit to emerging market and developing economies from worsening pandemic dynamics and tighter external financial conditions would set back their recovery and slow global growth.

Leading chip manufacturers see the ongoing global semiconductor shortage potentially stretching into 2023- confirming fears that the chip-supply disruptions currently hitting companies and consumers is unlikely to wane in the short-term. The worldwide shortage has fueled rising prices for several consumer electronic products. Also, the auto industry has been particularly hard-hit as the lack of key components has caused production delays and factory closures. German carmaker Volkswagen AG warned recently that the global shortage could worsen over the next six months. While Intel of the U.S. and Taiwan Semiconductor Manufacturing Co., are both adding new chip-production plants, this new capacity won't be available for about two years.

USA

The 2021 and 2022 growth projection have been revised upwards by 0.6 percentage points and 1.4 percentage points to 7% and 4.9%, respectively. This assumes that Washington's infrastructure and social spending programs will pass through Congress.

A fourth wave of covid-19 infections is sweeping across the U.S. The highest case numbers are in Louisiana, Florida and Arkansas; Missouri has the highest number of hospitalizations. Vaccinations are stuck at 60% of the population age 18 and older. The unvaccinated remain hesitant and skeptical while claiming the right to resist being told what to do. In addition, some unvaccinated folks refuse to wear masks. The renewed CDC advice to wear masks indoors will be a setback to the drive to get workers back to offices, students to schools and could have a dampening effect on the overall reopening of the economy.

Meanwhile, orders for cars, appliances, and other durable goods (meant to last at least three years) continue to increase, signaling continued strength in the U.S. recovery. Demand for durable goods has increased in 13 of the last 14 months. Low business and retail inventories have translated to increased demand for manufacturers, but supply-chain issues continue to constrain production and delay shipments. Despite the supply-chain challenges, the medium-term economic outlook remains relatively upbeat. However, U.S. growth is expected to ease from its breakneck speed recorded over recent months.

Faced with rising costs for raw materials, transportation, energy, packaging and workers, U.S. companies are charging more for products (including construction supplies, gasoline, household necessities, food, manufacturing inputs and services). This is helping to fuel inflation on a scale not seen in over a decade. As customers appear to accept higher prices, some companies say they expect additional price hikes will be forthcoming, as they are forced to pass on consistently higher costs to their customers. The Federal Reserve inflation gauge-the core personal consumption expenditure index- is expected to accelerate sharply this year (likely surpassing 4% for all of 2021). But if current supply constraints and other pandemic-related quirks were to ease, those pressures would be expected to fade and bring inflation down in 2022. In other words, both the U.S. Federal Reserve and the IMF still expect current inflationary spikes to cool over the coming months. Inflation of 2.5%-3% in 2022 is forecast.

U.S. household spending bounced back in June-July as consumers shelled out more on services at the start of the summer, but a current upswing in Covid-19 cases related to the Delta variant is injecting uncertainty into the economic outlook. Personal-consumption expenditures – a measure of household spending on goods and services-increased a seasonally adjusted 1% for the month. That followed a downwardly revised 0.1% drop in May, when consumers pulled back on purchases of goods but boosted spending on services. The spending report reflects that the economy is still very much on track. Any potential impact of the Delta variant's spread is difficult to predict, but could pose significant risk to economic growth if consumers curtail activities such as travelling and dining out. More recent figures on credit-card transactions show consumers spending eased in July. Rising inflation and the latest surge in virus cases could affect future spending trends. The spread of the Delta variant caused local governments and businesses to reimpose mask mandates, and the CDC has recommended that vaccinated people wear masks indoors.

Americans have been spending again as they resume activities outside the home since state and local governments eliminated covid restrictions earlier this year, a trend that has particularly benefited service-sector industries such as restaurants and travel.

China

China's growth has also begun to slow. The central bank has ordered lenders in Shanghai to tighten mortgage lending. Curbs have, so far, focused on sectors most popular with global investors. One inference is that Beijing does not like its companies raising capital overseas. This is both a matter of control and concern about possible exposure of sensitive data. There may also be wariness over a recent rush of funds into equity markets. The benchmark Shanghai Shenzhen CSI 300 index nearly doubled in two years. Those fears are not unfounded. Total market capitalization has reached $13 trillion. Valuations have broken records, surpassing levels in 2015 when a crash wiped out half of China's total market value in less than six months.

The MSCI China index, which covers the country's large and mid-cap companies, now has a price-to-book ratio of 2.3 – higher than the 2015 record of 1.8 prior to the crash. As retail investors make up 80% of the local market, sudden price declines have an outsized impact on households' financial income and consumption. Foreign investors hold $550 billion worth of local stocks. This is more than seven times their holdings in 2015 before China's market tanked.

Analysts have trimmed expectations for how quickly China will cut steel production. Steel production rose to a record in the first-half of 2021, but production is expected to fall in the second half as local governments cut spending. Prices stumbled recently, following signals that Beijing was easing the pace of plans to cut carbon emissions. The price of steel futures in Shanghai fell 6% following a meeting of China's leadership. After the meeting, the politburo urged a correction to "campaign style" carbon-reduction plans by local governments across China. The directive is meant to cool efforts to reduce carbon emissions by tightening controls on heavy industry, in order to safeguard economic stability.

China is committed to reaching peak carbon output by 2030 and become essentially "carbon neutral" three decades later. The leadership stressed the need to carry out the work to meet carbon targets in an "orderly and unified way". China has pledged to cut production in its giant steel industry, which accounts for 15% of national carbon emissions due to China's reliance on coal.

China's crude steel output fell 5.6% in June from a month earlier and trended lower in July. It is expected that further output declines would place upward pressure on the price of steel. China's politburo's comments have encouraged speculation about how Beijing will ensure that output does not exceed last year's record 1,054 million tons. Analysts predict steel production controls will be more gradually paced going forward. While China's steel production will decline in the 2nd half of 2021, annual production will still be up between 4%-5% compared with 2020.

The price of iron ore, which is needed to make steel, fell more than 11% at the end of July, sinking recently to a four month low of $180.50 per ton. Prices recovered a bit on expectations that global demand could eventually lift production.

Iron ore has been a key source of profits for big mining companies, and prices have come back strong from the depths of the Covid-19 crisis, climbing from $80 per ton to a record high above $233 in May on the back of both strong demand from China and supply disruptions. On the supply side, iron ore shipments from Brazil, Australia and South Africa are expected to pick up over the rest of 2021. This could place further pressure on prices. Based on recent production updates from leading miners, global iron ore output will rise 55 million tons over the next six months, a 10% increase over first-half 2021. Miners are bracing for lower prices ahead, warning that $200 a ton ore is unsustainable. Surging iron ore prices helped some companies deliver record half-year profits this year.

Meanwhile, China is reportedly becoming a net recipient of financial flows as more emerging countries are repaying more money to China than they receive in new disbursements for Chinese debt and equity investments. This reflects China's increasing focus on getting repayments for its investments, amid concerns about previously poor lending decisions. It is not clear whether this trend will persist post-pandemic; Chinese financial outflows may recover in 2022-23 as global economic prospects brighten.

Financial repayments to China will become an increasingly important issue for emerging countries in the coming years, fueling mutual interdependence. New data published by the World Bank show that China's net financial flows (debt and equity investments) turned negative in 2019 at -$1 billion, compared with a peak of $16 billion in 2016. Developing countries are now repaying more money to China than they receive in new disbursements.

China remains the biggest lender to emerging economies, but only accounted for 39% of financial flows to low-and middle-income states in 2019. This reflects a 29% reduction in net Chinese equity investments and a 48% drop in debt outflows from China to emerging countries in that year. The data highlight China's shift away from its position as a generous lender to the emerging world towards that of increasingly focused on receiving repayments.

Reimbursements from Angola, Samoa, Tajikistan, Dominica, Tonga, Ghana, Brazil and Jamaica proved especially large (as a share of their GDP) in 2019. Chinese financial flows are often channeled through special-purpose vehicles, which are not accounted for in World Bank figures. As a result, the apparent drop in Chinese outflows from China may be misleading.

The stock of inward foreign direct investment (FDI) to China rose from $587 billion in 2010 to $1.9 trillion in 2020. While global FDI fell last year by 35% to $1 trillion, inflows into China rose from $141 billion to $149 billion (no doubt reflecting perceptions of a very rapid recovery from Covid-19). Foreign investors also bought $35 billion of Chinese onshore equity stocks and $75 billion of government bonds in the first half of 2021. In each case this was a 50% increase over the buoyant pre-covid levels in 2019. Recent market turmoil suggests that developed world investors have underestimated the importance China's Communist Party attaches to control and social stability. Beijing is fully committed to cutting tech companies down to size and gaining a tighter control over data. The Chinese leadership is also determined to block U.S. Public Company Accounting Oversight Board from gaining access to U.S. listed Chinese companies' documents.

Looking ahead, any fall in Chinese outflows may well be temporary rather than a policy shift (although the Chinese government is rethinking its Belt and Road Initiative strategy, which may involve a tightening of previous lax conditions). The trend could be reversed in 2022-23 once the global economy has recovered from the pandemic and growth prospects pick-up in developing countries.

In the years ahead, financial repayments to China will become an increasingly important issue for many emerging countries. Debt owed to China is not treated as "sovereign debt" as part of the Paris Club, mainly due to China's use of parastatal entities to channel financial flows. This means that those emerging countries that are struggling to repay their debt obligations may need to negotiate arrangements on a bilateral basis with China. That will inevitably give China greater leverage to advance its economic and political interests. However, the inter-dependence goes both ways. In some cases, China will likely agree to debt restructurings in an attempt to recoup some of its investments. Cancelling interest payments or agreeing to restructurings in exchange for a share in state assets (as happened in Laos) are options.

Whatever the strategy, it will tend to increase the interdependence between China and emerging economies over the longer-term. Coupled with vaccine diplomacy, this points to greater Chinese influence in developing economies going forward. In some cases, growing resentment against Chinese lending practices could open windows of opportunity for Western countries to step in with new offers of their own to emerging country debtors.

Latin America

The region is among the worst hit by the pandemic with death tolls continuing to rise and reported new cases still high. The region's weak health systems, high poverty levels and large urban populations have been blamed for the high rates of Covid infections. With 8% of the world's population, Latin America has suffered nearly one-third of global deaths from the pandemic, as well as its worst recession in over 100 years. Vaccination rates are low because of the difficulty of securing vaccine supplies. Some countries have inoculated less than 10% of their populations. Officials overseas complain that U.S. and European governments have monopolized available stocks of vaccines.

Despite the impact of the pandemic, limited access to borrowing and shaky public finances have restricted how much Latin American countries can spend to mitigate rising poverty and unemployment . The UN Economic Commission for Latin America (ECLA) earlier this year said government debt in the region would likely rise from 68.9% to 79.3% of GDP between 2019 and 2020, making Latin America and the Caribbean the most indebted territories in the developing world. The IMF is close to agreeing a $650 billion issue of new special drawing rights, the largest such allocation in its history, in response to the pandemic. Latin America stands to receive $68 billion of the new issue, but some regional experts believe that this will not be enough to get the region out of its current problems. There have been discussions about redirecting IMF funds to the poorest nations, but this would exclude middle-income countries, the category covering most of Latin America. There are rising voices for a new IMF facility to redirect surplus resources from wealthy to middle-income countries. The concern is that if the economic crisis in Latin America gets deeper, there will likely be more protests in the streets. The consensus is that Latin America needs to come out of this pandemic with a new social contract where basic public services and social protection are adequately financed. Wealthy nations are being urged to immediately send surplus Covid-19 vaccines to the region as a first step. The U.S. Administration is responding with shipments of its surplus vaccines to various countries.

The latest data show that the jobs recovery in Latin America is lagging the overall economic recovery as the pandemic continues to hinder fully fledged economic normalization. Although job creation should pick-up in the coming months, the quality of the regional job market is likely to remain weak for much longer. As a consequence, living standards will likely remain weak for much longer, stoking the potential for labor and social unrest.

The IMF estimates that Mexico's economy will grow 6.3% in 2021. Previously the IMF estimated growth of 5% for Mexico. However, it was concerned about the slowdown in growth, the Delta variant of the pandemic and the withdrawal of stimulus. The Mexican economy rebounded 19.7% year-on-year in the second quarter of 2021, buoyed by good performance across all sectors. Industrial activity rose 28.2% year-on-year, while the services sector grew 17.1%. Both sectors have the largest impact on GDP. The agricultural sector grew 6.7%. Mexico, the second-largest economy in Latin America after Brazil, saw it economy contract by 8.3% in 2020, its worse contraction since the 1930's.

Brazil

The latest balance of payments data show that Brazil's current account surplus was lower than expected in June, at $2.8 billion, reflecting a substantial increase in imports. Net foreign direct investment (FDI) inflows were surprisingly weak, at just $174 million, the lowest monthly result in five years. Meanwhile portfolio investment inflows rose to $5.1 billion, the highest figure this year.

The smaller than expected current-account surplus in June does not reflect weaker export growth. In fact, Brazil's export earnings have accelerated, growing by a whopping 65% year-on-year amid a commodity mini-boom. Rather, import growth sped up, with the import bill rising more than 80% in June. The rapid growth indicates a recovery in domestic demand, as well as a high level of imports to the oil sector under the Repetrol special customs regime (which offers reduced import taxes on equipment destined for oil production and mining activities), as elevated commodity prices drive investment in the sector.

Notwithstanding the jump in imports, the trade surplus still came in at an impressive $7.3 billion in June. This contributed to a quarterly trade surplus of $23.3 billion, Brazil's largest-ever quarterly result. FDI was surprisingly weak with inflows of $174 million for June (reflecting a high level of disinvestment by foreigners) and net outflows of $2.6 billion. While one month's worth of data is not necessarily a trend, the April and May FDI figures were also weak. Inflows were at their lowest in a decade in the second quarter. In contrast, portfolio inflows have been strong, although outflows have picked up as well.

Brazil's short-term external dynamics remain favorable given a competitive exchange rate and improving terms of trade. However, the current-account is expected to shift back into deficit in 2022 as import demand recovers. The weak FDI results in June may be a blip, but upcoming election jitters in 2022 could keep FDI flows below potential. This trend will be closely watched.

In Brazil and Chile employment remains substantially below pre-pandemic levels. This is partly due to generous government payouts in both countries, which have allowed workers to delay their re-entry to the workforce. By contrast, in countries with relatively weak safety nets, such as Bolivia and Ecuador, workers have been forced to seek out jobs wherever they are available, leading to much stronger job growth. Currently, most unmet labor demand is concentrated in low-wage and informal jobs.

Insufficient job creation is keeping unemployment at record levels when considering the labor market as a whole, including informal workers. The 14.6% unemployment rate (with 14.8 million people unemployed) - rises to 29.3% including those who have dropped out of the labor market and have stopped looking for work. Unemployment is forecast to fall in the second -half of 2021, with the progress of vaccination favoring a resumption of economic activity, but the country will still experience high unemployment rates for some time. Most analysts forecast unemployment of 12.5% by the end of 2021.The uneven jobs recovery will constrain improvements to households' disposable incomes, increasing the likelihood of episodes of labor and social unrest.

The Brazilian economy is expected to return to its pre-pandemic size by end-2021, with real GDP expanding 4.2%-4.4% in 2021, up from 3.2% previously. The upward revision reflects the economy's unexpectedly strong performance in Q121, when GDP grew 1% y-o-y. High frequency data suggests that economic growth was resilient in the second quarter as pandemic restrictions were eased far more quickly than expected. The consensus 2021 growth forecast according to Brazil's central bank's survey of market participants is for GDP growth of 4.4%. In June the central bank raised the benchmark Selic interest rate by 75bps to 4.25%, with forecasts putting interest rate at 6.25% by year-end 2021. Inflation has continued to surprise on the upside over recent months, which has pushed up market expectations for interest rate hikes; leading the central bank to adopt a more hawkish policy stance.

Consumption now appears likely to continue normalizing over the coming months. Continued progress in vaccinations will also boost consumer sentiment and consumption. As of early June, 23% of the population had been vaccinated and the country remains on pace to have vaccinated a majority of its priority population [age 65 and over, others with underlying health conditions and healthcare workers] by the end of August. That would make Brazil among the furthest along in the region. As in other countries in the region (such as Chile and Uruguay) vaccinations are unlikely to lead to an immediate and sustained decline in new infections. Nonetheless, vaccinations should contribute to a significant decline in serious illness and death.

Improving sentiment among business and investors will likely generate positive feedback effects through new hiring and investments over the coming months. With the 2021 reopening more consumers are returning to malls; while others are shopping online, spending more in restaurants and more people are spending on trips. The Brazilian real is now the region's top performing currency in 2021. The rally is likely to help mitigate the downside impact on investment of the central bank's interest rate hikes and could help temper inflation (recently at 6.8% and climbing). It suggests markets may put less pressure on the government to narrow its budget deficit in the short-term, allowing more stimulus spending. We expect to see a strengthening of rail construction over the coming years, spurred by an uptick of investment in major rail infrastructure projects. Urban rail development will be a key driver of overall rail investment, with a number of projects set to see increased construction activity, most notably in Sao Paulo.

Improving confidence is increasingly likely to outweigh political volatility, although politics will likely remain a major source of downside risk in Brazil. However, for the time being, positive economic data and congressional leaders' apparent interest in advancing some reforms (including tax reforms and privatizations) have soothed market concerns over President Bolsonaro's interventionist bent. Bolsonaro's approval rating remains at approximately 25%, with disapproval nearing 50%, amid widespread dissatisfaction with his handling of the pandemic and the relatively uneven recovery thus far.

Ecuador

Ecuador's outlook has improved for the 2021-25 forecast period, reflecting the impact of changes that former President Lenin Moreno introduced towards the end of his tenure, as well as the explicitly market-friendly stance of the new president, Guillermo Lasso, who took office in May 2021. He will serve a four-year term. No party achieved a majority in the 2021 elections, and Mr. Lasso governs with a minority in the 137-seat National Assembly that is dominated by left-of enter parties.

Cognizant of the dire state of Ecuador's public finances, President Lasso will seek to attract foreign investment as way of engineering an economic recovery from the recession induced by the pandemic, lifting exports and creating jobs. He has pledged to place more emphasis on improving relations with Ecuador's main trading partners through free-trade agreements.

The central bank confirmed that Ecuador's trade balance registered a surplus of $1.5 billion in May. A growing surplus will help to reduce the country's balance-of payments vulnerabilities. The surplus is explained by a robust export performance and a tepid recovery in import spending. Export earnings have been expanding since they bottomed out in April 2020, when they fell to their lowest level since 2009. Rebounding quickly, year-to date export earnings were up 10% compared with the same period in 2019 (pre-pandemic levels). Oil export revenue is still below its 2019 level, but a recovery in oil prices has supported export earnings. Oil export revenues totaled $821 million in May – just shy of its May 2019 level of $835 million.

Much of the growth in exports have come from non-oil exports, which recorded an increase in revenue of 22% year-on-year in January-May 2021. Mining exports have boosted export revenue; May revenue from mining exports of $527 million was more than double its 2020 level and five times its 2019 level, driven by two major mines that came online in 2019.

Although Ecuador's export performance has been strong, the import data underline how tepid the recovery in domestic demand has been. The year-to-date import bill remains 4.5% below pre-pandemic level. Spending on consumer and capital goods, in particular, remains depressed. Whereas consumers and businesses in other countries were on the receiving end of significant fiscal support measures during the pandemic, in Ecuador, households and firms had little support from the cash-strapped government, which did not have the fiscal space to revive the economy. As a result, import spending has been slow to pick-up, and Ecuador's economic recovery is one of the weakest in the region.

The consensus is that the outlook for the external sector will remain positive. Import spending will gain some momentum as the year progresses, supported by a loosening of covid -related restrictions, but export earnings will continue to outstrip the recovery of imports. Boosted by a rising population but hindered by anemic economic growth, as well as a dearth of fiscal support measures during the pandemic, Ecuador's market size is expected to expand modestly.

The government of former President Rafael Correa (2007-17) invested the proceeds of the oil boom in upgrading the country's infrastructure. Substantial improvements were made in this period, particularly on the road system, but significant gaps remain. His successor Lenin Moreno (2017-21) was unable to do the same given the need for fiscal adjustments, and attempted to attract private investors to invest in infrastructure, but only with limited success. The new Lasso administration will endeavor to close infrastructure gaps by improving the legal framework to provide a moderate boost for investment (domestic and foreign), notably in the export-oriented energy and mining sectors, and related services.

As a result of dollarization and successive years of guaranteeing a "living wage" (essentially a minimum wage), Ecuador is no longer a cheap-labor investment location. In U.S. dollar terms, the country's minimum wage is one of the highest in Latin America. Also weighing on this country's competitiveness are low skills levels. However, dollarization facilitates greater overall macroeconomic stability for businesses to access investment opportunities, particularly by reducing inflation and exchange risks. Investments in most areas outside the oil sector will be slow to arrive, as improvements to the business environment will be incremental, given political hurdles amid a highly fragmented political landscape.

Reforms are required to bolster the integrity of the legal system. The Moreno administration attempted to stop political interference by the judiciary and curb graft, but results have been mixed. Inefficiency and corruption remain deeply rooted in the judicial system. The Council of the Judiciary has shown little progress in handling corruption cases, access to legal protection and law enforcement remains flawed, and effective protection of rights is still lacking.

The Lasso administration is expected to make piecemeal progress in bolstering institutions' capacity to tackle corruption, but significant improvements are unlikely. Anti-corruption initiatives have yielded few tangible results, and some efforts by Mr. Moreno were politically complicated given his unpopular position and lack of a majority in the legislature. Mr. Lasso will operate with even a smaller legislative support, hampering any efforts to advance anti-corruption legislation that may be deemed controversial to the opposition. The misuse of funds in public institutions and networks of corruption within the state will be difficult to root out.

South Africa

The ruling African National Congress and the president, Cyril Ramaphosa, are expected to expedite reforms, including boosting power supplies and fighting corruption, during the remainder of a challenging term, ending in 2024. Mr. Ramaphosa is eligible to serve a second term.

The pace of the recovery from the pandemic in 2021-22 will be modest. Growth will be driven by low interest rates, buoyant exports and a vaccine rollout, but will be held back by high unemployment and fiscal consolidation. Being commodity dependent, widely traded and an emerging-market proxy, the South African currency, the rand, will benefit from a positive global backdrop in 2021, but will remain vulnerable to adverse shifts in global sentiment and to negative domestic developments.

South Africa's market-determined exchange rate and its independent central bank mean that inflation risks are lower than many emerging markets, although growth lags emerging -market peers because of domestic structural constraints.

Unlike many African markets, South Africa will benefit from having independent institutions, such as the judiciary and the central bank. Having close relations with both the U.S. and China, South Africa could face tough decisions on trade and investment if tensions between the two superpowers escalate.

The Constitutional Court handed former president Jacob Zuma a 15-month jail term for defying its orders. Pro-Zuma factions orchestrated a backlash to the sentencing which resulted in widespread looting, the destruction of property, transport blockades and 117 deaths mainly in KwaZulu Natal (KZN) province and parts of Gauteng. Order has mostly been restored, helped by troop deployments to aid the overstretched police, but repairing the damage will exceed $690 million, and attacks on distribution and supply-chain disruption could last for several weeks.

The disorder is a major setback to economic recovery, but many observers view it as a potential catalyst for faster structural reforms. The violence will dent the remaining credibility of Mr. Zuma and his allies and could lead to new prosecutions.

Inflation after rising to 5.2% y-o-y in May, is now expected to face further pressure because of the recent disorders. Meanwhile, interest rates are expected to be maintained by the central bank at a record low of 3.5% for now. The next rate move is likely to be upwards, either late in 2021 or in early 2022, in line with global trends and potentially higher inflation. Stronger commodity prices and global liquidity injections will support the rand in 2021, as shown by an 18.7% year-on-year appreciation of the currency in June – its strongest level in over two years.

The government's most immediate policy challenge is to revive the economy after a pandemic-induced 7% contraction in 2020, which inflicted lasting damage on many households and companies. GDP growth of 3% is forecast for 2021, driven by a mildly better than expected first quarter outcome. Factors supporting growth in 2021 include an improved outlook for vaccine provision, higher commodity prices, stronger export demand, another good farm season and the maintenance of low interest rates.

By Byron Shoulton, FCIA's International Economist
For questions / comments please contact Byron at bshoulton@fcia.com