

South Africa

Engine failure

Economic growth is forecast at only 0.4% in 2019, after averaging 1% a year in 2015-2018. The Ramaphosa government has little manoeuvring room to implement reforms, and strong structural headwinds continue to hamper economic activity. Illustrating the country's enormous lack of infrastructure, major power outages disrupted activity in the first months of the year. To address the severe financial troubles at Eskom, the state-owned company behind the power outages, the government had to unblock additional funds to come to its rescue. The latest rescue package will accelerate fiscal deficit slippage and further weaken sovereign solvency in the medium term.

South Africa's real GDP growth averaged 1% a year between 2015 and 2018, far short of what the country needs to boost per capita income; population increased by 1.7% a year over the same period. Economic growth has been weak since the beginning of the year and is unlikely to improve much in the very short term. The central bank eased monetary policy slightly last summer, but the government has no choice but to maintain a restrictive fiscal policy. Yet this will not prevent the public deficit and debt from increasing rapidly this year.

■ Very slow economic growth

After hitting another air pocket in Q1 2019, real GDP growth picked up slightly in Q2, reaching 3.1% q/q sa (vs. -3.1% in the previous quarter) and 0.9% y/y (vs. 0% in Q1). Leading indicators and recent activity data point to another slowdown in Q3. We are projecting full-year real GDP growth of only 0.4% in 2019.

The power outages arising from the troubles at the state-owned company Eskom hit the primary and secondary sectors particularly hard, especially in the first months of the year. A strike also blocked a major gold mine from November 2018 until a wage agreement was signed in April. Mining sector activity (7% of total GDP) contracted by 4.6% y/y in Q1 2019 and then by 2.1% in Q2. Growth in the manufacturing sector (which accounts for only 12% of GDP) slowed to 0.5% y/y in H1; it probably slipped into negative territory in July-August according to the industrial output index. The agricultural sector was hit by another sharp decline in production (down 12.7% in Q1 and 6.7% in Q2), while the troubles in the construction sector persisted (-2.4% in H1). The services sector reported growth of 1.5% in H1, roughly in line with the average for the past four years. The finance and real estate sector (18% of GDP) continued to report the most buoyant performance.

From the demand standpoint (chart 2), real GDP growth was undermined by the negative contribution of net foreign trade in Q2 2019. This decline is likely to continue in the short term in a weak international environment. Private consumption (60% of GDP) rebounded in Q2 (+1.4% y/y) after slowing for several quarters, in part thanks to a slight acceleration in household lending. It could drop off again in the short term given the deterioration in the labour market and the feeble increase in real revenues. Employment declined slightly in Q1 and the unemployment rate rose to an all-time high of 29% in mid-2019.

1- Forecasts

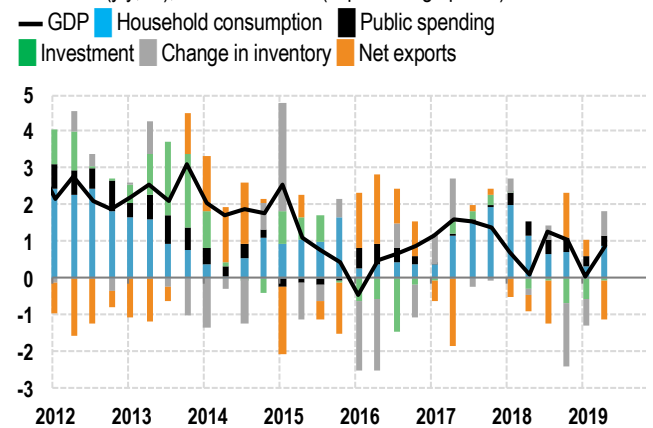
	2017	2018	2019e	2020e
Real GDP growth (%)	1.4	0.8	0.4	0.8
Inflation (CPI, year average, %)	5.3	4.6	4.2	4.5
Gov. balance / GDP (%) ¹	-4.4	-4.2	-6.1	-5.8
Gen. Gov. debt / GDP (%) ¹	52.7	56.5	60.0	65.0
Current account balance / GDP (%)	-2.4	-3.6	-3.3	-3.6
External debt / GDP (%)	45.8	51.1	52.0	54.0
Forex reserves (USD bn)	45.5	46.5	43.5	45.0
Forex reserves, in months of imports	4.7	4.4	4.0	4.0
Ex change rate USDZAR (y year end)	12.4	14.3	14.5	13.7

(1): Fiscal year from April 1st of year n to March 31st of year n+1

e: BNP Paribas Group Economic Research estimates and forecasts

2- Sluggish growth

Real GDP (y/y, %), and contribution (in percentage points) *



Source: Statistics South Africa * The residual component is not shown.

One alarming signal is very weak investment, which has declined continuously since Q1 2018. The investment ratio fell below 18% of GDP, down from a 2011-2015 average of 20.5% of GDP. This trend could continue in the short term given the weak prospects for external and domestic demand, and due to the further erosion in investor sentiment.



■ No manoeuvring room

The confidence that was restored following the inauguration of President Ramaphosa in February 2018 proved to be short lived. The high hopes that were raised with the announcement of reforms (notably to improve public finances, fight corruption and raise the potential growth rate) and the implementation of the first measures have been dashed and replaced by fears of paralysis. As a matter of fact, the government's manoeuvring room for implementing reforms is severely constrained by low economic growth, a very tense social climate and deep-running divisions within the ruling party. The significant structural headwinds that are hampering investment and GDP growth (lack of infrastructure, lack of skilled labour, labour market rigidity, corruption and uncertainty over future changes in the legal framework in certain sectors) are bound to persist. The authorities also have very little manoeuvring room to stimulate activity in the short term.

The central bank lowered its key repo rate by 25 basis points (bp) to 6.5% in July 2019; its previous action was a rate increase by a similar amount in November 2018. Monetary policy could be eased slightly further in Q4 2019, since consumer price inflation is holding comfortably within the target range of 3-6%. Inflation averaged 4.3% y/y in the first eight months of the year, compared to 5% in H2 2018. The central bank will nonetheless remain cautious. The financial markets have enjoyed a relative calm since the beginning of the year and the rand has depreciated by less than 3% against the US dollar. However, new episodes of capital flight and pressures on the rand are possible in the short term in case of an external shock, bigger-than-expected fiscal deficit slippage and/or if Moody's were to downgrade its sovereign rating (the next review is scheduled for early November). If South Africa's sovereign rating were downgraded to speculative grade, it could trigger a large sell-off of public debt bonds by investors.

■ Accelerated deterioration in public finances

Public finances have deteriorated gradually over the past decade due to insufficient fiscal revenues, rising debt and interest payments, and recurrent losses reported by state-owned companies. The situation has deteriorated even faster this year.

From fiscal year 2014-15 to fiscal year 2018-19 (FY, starting April 1st and ending March 31st), the central government deficit held between 4% and 4.5% of GDP, and debt swelled from 47% of GDP to 57%. Although efforts to contain spending increases and to boost revenues helped reduce the primary deficit to less than 1% of GDP last year, compared to 2.7% in FY2012-13, the nominal deficit did not improve due to the increase in debt interest payments. These accounted for 3.7% of GDP in FY2018-19, and 14.3% of fiscal revenue.

In FY2019-20, the nominal deficit should deteriorate significantly, rising above 6% of GDP (overshooting the government's initial target of 4.5%). While interest charges continue to rise (to an estimated 4.5% for the full fiscal year), the primary deficit is also deteriorating rapidly (chart 3). It could reach 1.6% of GDP in FY2019-20. The much bigger increase in spending can be attributed to the government's additional support to rescue the state-owned company Eskom.

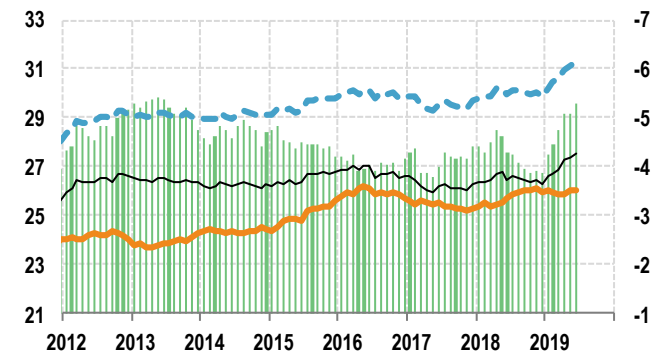
3- The fiscal deficit is deteriorating rapidly

% of GDP, 12-month moving average

■ Central government deficit (rhs, inversed scale)

— Fiscal revenues - - - Total fiscal spending

— Primary spending (before interest payments)



Source: Statistics South Africa

Initially, Eskom was to receive support of ZAR 23 bn a year over ten years starting in 2019. This figure was raised to ZAR 49 bn for FY2019-20 and ZAR 56 bn for FY2020-21 (or about 1% of GDP a year), with part of the funding being early payments of the financial support plan previously scheduled for the longer term. This support package must be accompanied by a corporate restructuring plan and debt rescheduling for Eskom, and part of the debt guaranteed by the central government will probably be transferred to its balance sheet. There is a high risk that other state-owned companies may need direct government support going forward. Moreover, the government has almost no capacity to reduce other expenditures or to boost revenues given the sluggish pace of economic growth, fierce social tensions at a time of high unemployment and poverty, and very poor-quality public services.

Government debt is likely to reach at least 60% of GDP by the end of FY2019-20 and 65% at the end of FY2020-21. While South Africa's medium-term solvency continues to deteriorate, the liquidity and refinancing risk of government debt in the short term has also increased. Nonetheless, it remains moderate thanks to a still favourable government debt profile and the existence of a large local-currency bond market. The average maturity on central government debt is long (at 15 years) and it is mainly denominated in rand (about 90% of total debt). Yet, with 40% of domestic debt held by non-residents, the government is vulnerable to changes in the sentiment of international investors. This sentiment could erode in the coming months in response to the rapid widening in fiscal deficits.

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