# SOUTH AFRICA



## GOING FROM BAD TO WORSE

**The shock triggered by the Covid-19 epidemic has been violent and has hit an already very fragile economy. Over the past five years, economic growth has averaged only 0.8% and the country has slipped into recession since mid-2019. The economic contraction and the deterioration in public finances will be on an unprecedented scale in 2020. Real GDP may well not return to its pre-crisis level before 2025. The government has been adept in adjusting its financing strategy to cover its needs, which have increased steeply following the introduction of the fiscal stimulus plan. The support expected from multilateral lenders in the short term is reassuring, but trends in government debt will continue to be a concern over the medium term.**

## A VIOLENT ECONOMIC SHOCK WITH LONG-LASTING EFFECTS

A strict lockdown has been imposed on all South Africans since late March. It has been relaxed slightly since May 1st, but the path of the epidemic has led the authorities to re-tighten restrictions in recent days. As a matter of fact, the epidemic has started slowly but accelerated alarmingly in recent weeks. It had not reached its peak by July 15th, at which point South Africa already recorded 311,000 cases and 4,450 deaths, in a population of 59 million.

The economic consequences of the health crisis are severe, especially as they hit an already very fragile economy that has been in recession since mid-2019. Real GDP growth averaged only 0.8% per year between 2015 and 2019, held back by significant structural constraints and brought to a virtual standstill last year due to major power outages. In Q1 2020, before the direct effects of the lockdown started to be appear, real GDP contracted by an annualised 2% quarter-on-quarter (following contractions of 0.8% in Q3 2019 then 1.4% in Q4 2019). During the lockdown, economic activity collapsed across all sectors in April, and then saw a timid recovery. For instance, manufacturing production plunged by 44% month-on-month (m/m) in April and by 49% year-on-year (y/y). The Purchasing Managers Indexes (PMI) suggest that production picked up in June, but remained well below its pre-crisis levels (chart 1).

The economy is likely to face an unprecedented contraction in Q2 2020, before a difficult recovery in the second half of the year, assuming that the country has moved past the peak of the epidemic by then. After an expected recession of 8.5% in 2020, the economic recovery in 2021 is likely to be limited, constrained by South Africa's very low potential growth rate (estimated at 1.5% before the health crisis). Based on our current estimates, real GDP is unlikely to return to its pre-Covid-19 crisis levels until 2025.

The social context, with very high levels of poverty, income inequality and unemployment, will worsen still further. The official unemployment rate hit 29.1% at the end of 2019 (and 57.1% amongst those aged 15 to 24), and already climbed to 30.1% by Q1 2020. The social impact of the Covid-19 crisis could be mitigated by the government's support measures but, one the one hand, the fiscal room for manoeuvre is limited and, on the other hand, the impact of the measures will be limited by the large size of the informal economy (which represents around 30% of employment). Households will at least benefit from slower consumer price inflation. Prices increased 2% y/y in May 2020 (from 4% in December 2019), the lowest inflation rate of the past fifteen years. Inflation is likely to remain between 2% and 3% over the next few quarters, with deflationary pressures from falling demand and lower oil prices more than offsetting the opposing effects of a weaker rand. This trend in inflation widens the central bank's scope to ease monetary policy (the monetary authorities have an inflation target of between 3% and 6%). The policy interest rate has been cut by 275 basis points since the beginning of the year (taking the repo rate from 6.50% to 3.75%). Further cuts are likely in the second half of 2020, unless South Africa's financial markets come under stress again.

**FORECASTS**

| | 2018 | 2019 | 2020e | 2021e |
|---|---|---|---|---|
| Real GDP growth (%) | 0.8 | 0.2 | -8.5 | 2.3 |
| Inflation (CPI, year average, %) | 4.6 | 4.1 | 2.8 | 3.7 |
| Government balance / GDP (%) 1 | -4.7 | -6.7 | -14.5 | -11.0 |
| Government debt / GDP (%) 1 | 56.7 | 63.4 | 82.1 | 88.8 |
| Current account balance / GDP (%) | -3.6 | -3.0 | -0.9 | -2.9 |

(1): Fiscal year from April 1st of year n to March 31st of year n+1
e: ESTIMATES AND FORECAST
TABLE 1
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

**SUDDEN STOP**

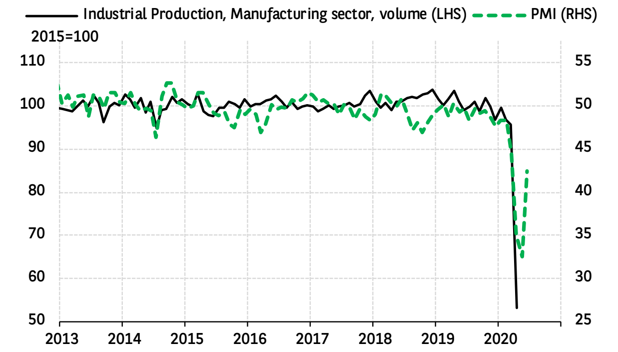


CHART 1
SOURCE: SSA, DATASTREAM

## THE FINANCIAL SHOCK WAS TEMPORARY BUT MAY BE REPEATED

South Africa was one of the hardest hit by the emerging market sell-off episode in Q1 2020. Large capital outflows led to sharp price corrections across all asset categories. The rand lost more than 30% against the

US dollar over the first four months of the year, before gaining 8% since end-April. In spite of the monetary policy easing, yields on 10-year sovereign bonds jumped from an average of 9.1% in December to 11.2% in April, and have since fluctuated at around 10%. Meanwhile, South African EMBI spreads more than doubled to 670 basis points over the first four months of 2020, before falling back to 520bp at the beginning of July.

In fact, financial tensions appear to have been easing since May. South Africa nevertheless remains one of the emerging economies most exposed to the risk of a downturn in foreign investors' sentiment, given its weak macroeconomic fundamentals. While its current account imbalance is likely to narrow this year (thus supporting the rand) due to the drop in imports and improved terms of trade, public-account dynamics are very worrying.

## PUBLIC FINANCES UNDER THREAT

The deterioration in public finances, which was already a cause for concern before the health crisis, will worsen much further this year. The central government deficit was 6.7% of GDP during fiscal year FY2019-20 (which runs from April to March), up from 4.7% in FY2018-19 and 3.9% in FY2016-17. Fiscal slippage has resulted from the weakness of fiscal receipts, growing current spending and rising interest payments on debt; all this was further exacerbated last year by the cost of bailing out state-owned company Eskom. The government's primary deficit thus increased from 1% of GDP in FY2018-19 to 2.8% in FY2019-20, its highest level in the past decade. Debt interest payments reached 4% of GDP, swallowing up nearly 14% of fiscal receipts. Although this figure is still not excessive, it is at a record level for the country and will increase still further over the next few years.

Fiscal deficit slippage is now set to accelerate as a result of the economic recession and the massive stimulus package introduced by the government since the end of April. This plan is worth ZAR 500 billion (USD 27 bn), or around 10% of GDP. It includes: ZAR 140 bn in support to struggling companies to help pay wages and protect jobs; ZAR 70 bn in tax cuts for enterprises; ZAR 50 bn in subsidies to households; ZAR 40 bn in new spending in the health sector (staff, infrastructure); and a bank loan guarantee programme (for a total of up to ZAR 200 bn, or 4% of GDP).

The Unemployment Insurance Fund will draw on its reserves to help finance measures to support employment. Other measures will be financed by budget reallocations (notably to the detriment of public investment). The remainder will be an additional cost for central government. In all, the deficit is expected to more than double in FY2020-21, taking it to 14.5% of GDP. With debt redemption totalling ZAR 65 bn, the government's financing needs will reach nearly 16% of GDP in FY2020-21, up from 8% in 2019-20. This substantial increase comes at a time when the deterioration of the public finances over recent years has led to downgrades of sovereign ratings by international agencies, increasing risk aversion amongst foreign investors and a rising cost of financing for the government. The authorities have thus had to adjust their financing strategy in response.

One point of comfort for the government is that nearly 90% of its debt is in rand and local financial institutions make up the bulk of its creditors. Banks, insurers and pension funds held 52% of local Treasury bonds at mid-2020 (from 48% at end-2019). Such institutions should be able to cover almost half of the government's borrowing requirements this year (or around 7% of GDP), but not more, especially as the banks have already bought up a large share of the securities sold by foreign

GOVERNMENT DEBT: A WORRYING TREND

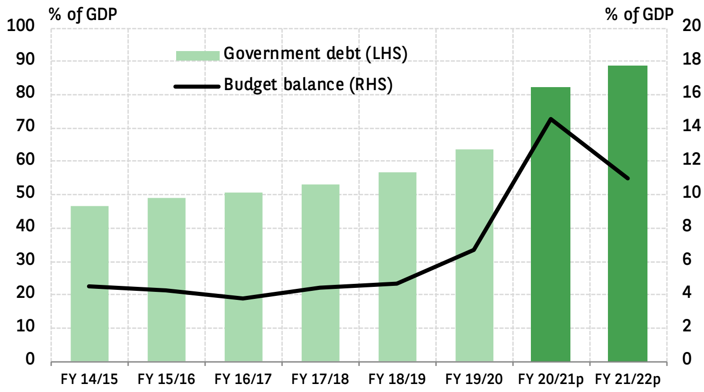


CHART 2

SOURCE: SSA, SARB, BNP PARIBAS

investors in recent months. Foreign investors held only 30% of local-currency Treasury bonds at end-June, down from 37% at end-2019, and their withdrawal is likely to continue in the short term. As a result, the government plans to draw on its deposits and reserves (for an amount equivalent to 2.5% of GDP) and hopes to borrow in international markets (for a total of some 0.5% of GDP). It will also turn to new sources of financing. Firstly, it has been negotiating with multilateral creditors to arrange financing of about USD 7 bn (or 2.5% of GDP). The IMF's 'rapid financing instrument' could provide USD 4.2 bn, with the rest coming from the BRICS' New Development Bank (USD 1 bn), the World Bank and the African Development Bank. Secondly, the central bank has begun to purchase Treasury bonds on the secondary market. Its purchases amounted to ZAR 20 bn at end-June (around 0.5% of GDP) and could climb to 2% of GDP over the year as a whole. The sums committed by the central bank would thus be modest and are unlikely to have a significant macroeconomic effect.

The rapid deterioration in sovereign solvency is a cause for concern. Total government debt had already risen from 51% of GDP in March 2017 to 63% in March 2020, and is projected to hit 82% by March 2021 due to larger deficits and shrinking nominal GDP (plus a small effect from the depreciation in the rand). Only major structural reforms, notably ones that increase South Africa's potential economic growth rate, will be able to change the trend in government debt over the medium term. Therefore, even when the health crisis is over, the Ramaphosa government will still face an immense challenge.

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