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SOUTH AFRICA AT A CROSSROADS

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The macroeconomic outlook for South Africa is gloomy. After a year of unprecedented electricity shortages in 2023, economic growth is only expected to rebound very slightly in 2024. However, investor confidence has been boosted with new political forces entering into government in June 2024, following the general election in May. The new coalition government, with populist parties largely absent, offers the prospect of a degree of political continuity, continued fiscal consolidation and the implementation of reforms designed to increase the medium-term economic-growth potential. However, this government of national unity is built on uneasy alliances. Any political paralysis resulting from a major disagreement between the parties could quickly jeopardise investor confidence, which is already very fragile. This would result in a significant deterioration in the external accounts and public finances, which are already on a worrying trajectory.

THE END OF THE ANC'S POLITICAL HEGEMONY

For the first time since it came to power in 1994, the African National Congress (ANC) party failed to win an absolute majority in Parliament in the May 2024 general election. Instead of a coalition with a single party, which the ANC would have needed to keep on side in order to remain in power, it opted to form a government of national unity. This government, which is made up of ten political parties, excludes populist parties in particular and offers the prospect of a degree of political continuity. However, this coalition could turn out to be fragile in the medium term and increase the risk of political paralysis should there be a major disagreement.

The ANC's waning popularity

Over the past ten years, the ANC has failed to address the concerns of its electorate. In the run-up to the May 2024 general election, polls indicated that corruption, crime, unemployment and deteriorating public services were the main reasons behind the party's waning popularity. In 2023, South Africa ranked 83rd (out of 180 countries) in Transparency International's Corruption Perceptions Index, down 4 percentage points (pp) from 2016. Years of widespread corruption involving party officials, particularly under former president Jacob Zuma (2009-18), have severely tarnished the ANC's reputation. In addition, the party has failed to reduce crime. In 2023, the World Bank estimated that the cost of crime (including theft, security expenditure and indirect losses in terms of loss of earnings and development opportunities) was 10% of GDP, while Statistics South Africa reported an increase in crime from pre-pandemic levels across all categories of crime. In particular, South Africa has one of the highest homicide rates in the world. With rising unemployment and worsening electricity shortages at the same time, the ANC launched its election campaign in a very difficult position.

The ANC's waning popularity is also due to infighting. This has led to the birth of rival parties which have cannibalised its electoral base. Since as far back as 2013, popular support for the ANC has dwindled, partially due to the creation of the Economic Freedom Fighters (EFF), a political party drawn from the radical wing of the ANC. More recently, in December 2023, Jacob Zuma broke away from the ANC by creating the dissident uMkhonto we Sizwe (MK) party. Despite a public enquiry to investigate whether Jacob Zuma was responsible for so-called 'state capture' during his years in power, and because no charges have been brought, he still enjoys strong popularity, particularly in KwaZulu-Natal, South Africa's second most populous province and home to the Zulu ethnic group to which Jacob Zuma belongs. Together, the breakaway EFF and MK parties won 25% of the total vote in the May 2024 general election.

As a result, the ANC lost its absolute majority in Parliament for the first time since the end of the apartheid regime and the first multi-racial election, held in 1994. The party won just 40.2% of the vote in last May's election, a result broadly in line with poll forecasts in the months leading up to the election.

The ANC in a government of national unity

Despite being somewhat historically and ideologically close to the EFF and MK, in the end, the ANC did not opt to form a coalition government with either of these parties, which it would have needed to keep on side in order to remain in power. Instead, it opted to form a government of national unity (GNU), which has enabled it to secure as many seats as possible in Parliament. Made up of ten parties, the GNU holds just over 70% of the seats in the legislative body. It is built in particular on keeping the Constitution as it is, a principle that immediately ruled out the participation of Jacob Zuma's MK, which had promised to reform it. The EFF refused to join the GNU because of the participation of the Democratic Alliance (DA), which is at the opposite end of the spectrum to its own political positions.

With no populist parties in government, a degree of political continuity is likely to prevail in the short to medium term. During the inaugural session of the new Parliament, President Cyril Ramaphosa was re-elected for a second 5-year term, with 283 votes out of 327 cast. In addition, the entry into government of the DA, a centre-right party in favour of free-market policies, should ensure the continuation, or even acceleration, of reforms aimed at stimulating economic growth through increased private-sector involvement in key sectors (such as electricity, railways, ports and water). Fiscal consolidation, through reductions in public spending, is also expected to continue. In addition, the quality of governance could improve, as the ANC, having lost its absolute majority, should be more accountable to Parliament for its decisions.

However, the GNU's internal alliances may seem uneasy. With 22% of the seats alone, the DA is a linchpin of the GNU, and its participation is crucial if the government is to enjoy an absolute majority. As the main opposition party over the last twenty years, the DA has frequently criticised the ANC vehemently for its incompetent governance and the corruption scandals that have tainted it. Its participation in the government stems more from its desire to keep out the populist parties than to govern with the ANC. Furthermore, its liberal stance on economic issues is at odds with the most radical left wing of Ramaphosa's party. As a result, the GNU coalition could weaken or even collapse, particularly on key issues such as the presentation of the 2025/26 budget next February.

In short, political risk has reduced following the general election in May 2024, as shown by the fall in the sovereign risk premium on government bonds since last May. However, uncertainties remain. Indeed, a government of national unity without any party with an absolute majority is an unprecedented situation for the country. For example, municipal coalition governments, following the ANC's poor results in the 2021 local elections, have proved highly unstable. Furthermore, even if the GNU enjoyed sustained stability in the medium term, South Africa would need several years in order to sustainably restore its economic growth potential, given the large number of reforms to be implemented.

ECONOMIC GROWTH: ONE STRUCTURAL OBSTACLE AFTER ANOTHER

South Africa's very low economic growth is a major vulnerability in the country's risk profile. Between 2015 and 2019, economic growth averaged just 1% a year, well below the population growth rate of 1.5%. The shock of the pandemic compounded years of near-stagnation in the economy, and the modest recovery that followed in 2021-22 was interrupted by the tightening of monetary policy, with the central bank's (SARB) main policy rate raised by 425 basis points (bps) between February 2022 and May 2023 to 8.25%. Real GDP per capita has been on a downward trend since 2014 (*chart 1*). The growth rate is nowhere near enough to reduce unemployment and poverty, which are at the root of recurring social unrest. Weak growth is also a major constraint on the trajectory of public finances. Reforms aiming to increase the medium-term economic growth potential are underway, but the slow process is a major source of concern.

Economic growth hampered by the energy crisis…

After the post-COVID recovery in 2021 and 2022, economic growth slowed sharply to just 0.7% in 2023. The main reason for this is increasingly deficient infrastructure following a decade of under-investment, mismanagement and corruption within the state-owned companies that control key sectors, most notably, electricity and transport. Power cuts imposed by state-owned Eskom reached a record high in 2023, with 335 days of load shedding, including 199 days at levels 4 to 6, considered critical (compared with 205 days of load shedding in 2022, including 93 days at levels 4 to 6). According to the SARB, the electricity shortage subtracted 1.5 pp from the real GDP growth rate. In addition, activity has been adversely affected by logistical bottlenecks due to rail infrastructure theft and port congestion. On average, in 2023, the rail freight volume fell by 27% compared with 2015, while port freight fell by 11% (*chart 2*).

Efforts to address the deterioration in infrastructure led to a recovery in investment in 2022-2023 (4.3% per year on average), following years of contraction from 2014 to 2019, which were compounded in 2020-2021 by the COVID crisis. This recovery, mainly driven by private sector investment (72% of total investment), has benefited in particular from the gradual deregulation of the electricity sector from 2022, which has increased production capacities in this sector. However, at 15% of GDP, the total investment rate remains below its 2011-15 average (18% of GDP). Above all, this is only half of the investment rate of upper-middle-income countries, a category to which South Africa belongs, which have an average investment rate of 34% of GDP.

REAL GDP PER CAPITA IN PURCHASING POWER PARITY

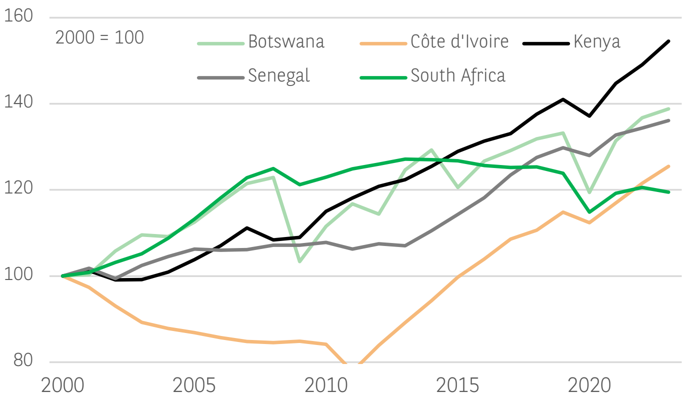

CHART 1 SOURCE: IMF, BNP PARIBAS

INFRASTRUCTURE DEFICIENCIES

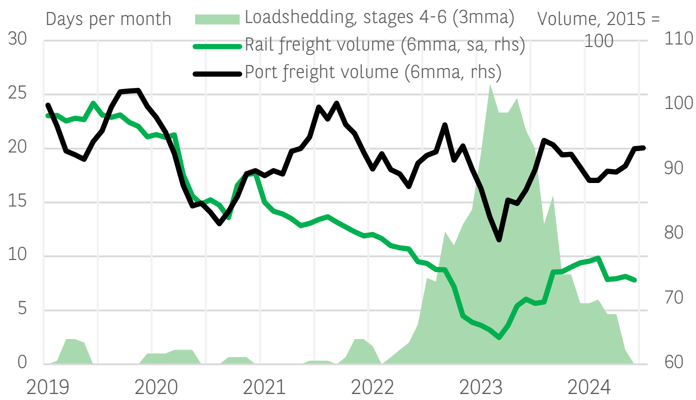

CHART 2 SOURCE: ESKOMSEPUSH, STATS SA, TNPA, BNP PARIBAS

In 2024, economic growth is expected to accelerate slightly to 1%. However, poor infrastructure continues to adversely affect real GDP, which grew by just 0.4% in H1 2024 compared with H1 2023. Admittedly, the power cuts have stopped recently, thanks to the deployment of private generation facilities and a number of Eskom power stations getting back in operation, which has allowed for the interruption of load shedding since the end of March 2024. However, logistical bottlenecks persist, partly due to delays in opening up the transport sector to private operators. In July 2023, Transnet chose the Philippine company ICTSI for the partial privatisation of the container terminal at the Port of Durban, following a selection process that began in 2021. The Durban terminal, which handles 46% of the country's port freight, regularly faces congestion problems. ICTSI was due to begin operations at the Port of Durban in April 2024, but legal obstacles have so far delayed the process. This privatisation was intended to set a precedent for privatising other logistics segments in the country, but its difficult implementation could deter potential private investors. In all likelihood, the insufficient and ageing infrastructure will continue to curb a stronger recovery in growth, particularly for the mining sector (6% of GDP) and for goods exports (29% of GDP).

Furthermore, inflationary pressures are still a major constraint for the central bank. Admittedly, the rise in the consumer price index (CPI) has been back within the SARB's target range (3-6% year-on-year) since June 2023, but persistent inflationary pressures in H1 2024 and the delay in monetary easing in the US have prompted the SARB to continue sitting on its hands. In August 2024, CPI growth nevertheless fell back to 4.4% y/y, slightly below the SARB's preferred target of 4.5% (*chart 3*). This enabled the central bank to cut its key rate for the first time, from 8.25% to 8%, at its September Monetary Policy Committee meeting. However, back in April, the Governor of the South African Reserve Bank mentioned that the inflation target could be lowered by 2025, with the aim of making the South African economy more competitive. If confirmed, this decision could reduce the scale of the monetary easing cycle.

...and the slow pace of structural reforms

In October 2020, the Ramaphosa government launched a package of structural reforms, known as Operation Vulindlela, aimed at boosting economic activity. The pace of the reforms was sluggish in the first few years, but did accelerate in 2023, with tangible successes in the electricity sector (stimulating investment and deregulation of the sector). However, the sector still requires further reform. In particular, the process of dividing Eskom into three separate legal entities in order to manage electricity generation, transmission and distribution separately is crucial to increasing competition and efficiency in the sector.

Beyond the electricity sector, other reforms are underway. In the logistics and transport sector, the new board of directors of the Transnet National Port Authority is expected to endorse the creation of a port entity independent of Transnet, again with the aim of promoting competition within the sector. In the mining sector, a new cadastral system, approved in February 2024, should improve exploration prospects and stimulate future investment in the medium term. In the water treatment and distribution sector, the government tabled a bill creating an independent national agency responsible for managing and financing water infrastructure and resources (NWRIA). Finally, a law has been passed to accelerate the roll-out of telecommunications infrastructure.

Removing the obstacles to human capital development

While South Africa already had the highest Gini coefficient in the world (0.63 in 2014, according to the World Bank), inequality has increased since 2020. In 2024, the National Treasury predicts that 9 million South Africans, or 15% of the population, will benefit from the Social Relief of Distress (SRD) grant, introduced in 2020 in order to protect households from the impact of the COVID-19 pandemic. Given the tense social climate, the grant has been renewed every year until now, and there are plans to turn it into a universal basic income. More generally, 50% of households receive at least one grant from the South African Social Security Agency (Sassa), and for 25% of them, grants are their main source of income.

DELAYED MONETARY LOOSENING

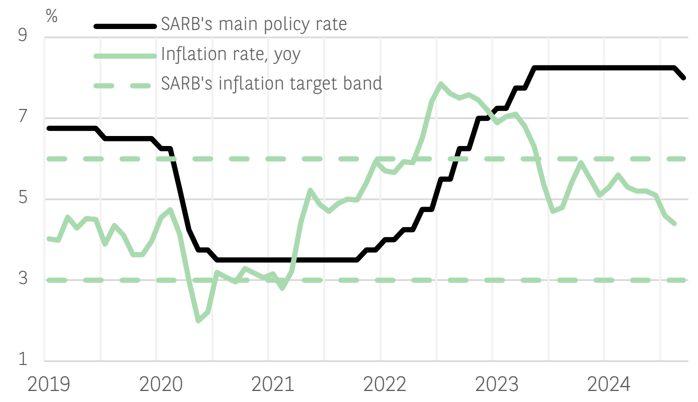

CHART 3

SOURCE: SARB, BNP PARIBAS

VERY HIGH UNEMPLOYMENT RATES

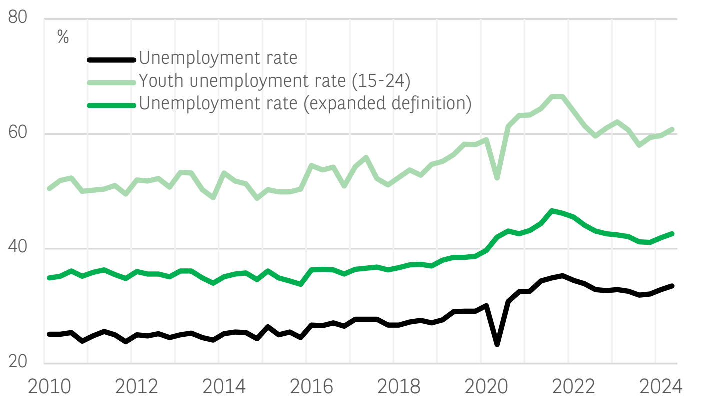

CHART 4

SOURCE: STATS SA, BNP PARIBAS

Economic growth is far from high enough in order to balance the labour market. In Q2 2024, the unemployment rate stood at 33.5% of the population, 4 pp higher than in 2019. The broader unemployment rate, which takes discouraged jobseekers into account, stood at 42.6%, and among young people (aged 15-24), it even surpassed 60% (*chart 4*). With no sustained rebound in economic activity over the next few years, the unemployment rate is set to remain high. Such a scenario could have detrimental long-term consequences for the skills levels of workers, and even for the labour-force participation rate. Standing at 65.6% in Q2 2024, this participation rate was below its pre-pandemic level (66.3% in Q4 2019).

Far-reaching reforms will be needed in order to rebalance the labour market, which features a significant mismatch between the supply of workers' skills and the demand from businesses. The *Skills supply and demand in South Africa* report, published in 2022, shows that the qualifications awarded by the South African education system are increasingly irrelevant to the labour market, particularly for highly skilled jobs. According to the OECD, in 2022, only 50% of 25-34 year-olds had a higher secondary education qualification, and only 1% of them had a master's degree (or equivalent). Public spending on education as a proportion of GDP is one of the highest in the world (6.2% in 2022), but a lack of policy coordination and government intervention is making the education system less effective.

PUBLIC FINANCES: A TRAJECTORY THAT NEEDS TO BE CORRECTED

Public debt has risen rapidly in recent years as a result of large primary fiscal deficits until 2021, the increased interest burden on debt and the multiple financial bailouts of state-owned companies. However, since the 2022/23 fiscal year (FY22), the primary balance has no longer been in deficit. With the reappointment of Enoch Godongwana as Minister of Finance and the DA's participation in the government, fiscal consolidation is expected to continue over the next few years. However, given the weak economic growth, the challenge will be considerable. According to the IMF, the already high government-debt-to-GDP ratio (74% of GDP at the end of 2023), is expected to continue rising over the next few years.

Fragile fiscal consolidation

In FY23, the deficit stood at 4.6% of GDP, the same level as the previous year. However, the government managed to generate a primary surplus of 0.4% of GDP (*chart 5*), despite multiple pressures. Government revenue was lower than expected, mainly due to the decline in revenues from corporate income tax (-11%). The latter hit a record level in 2022, buoyed by the exceptional performance of the mining sector, which was benefiting at the time from high global prices for minerals and metals. In 2023, commodity prices started falling again, contributing to a 0.9 pp drop in government revenue, to 24.2% of GDP. On the expenditure side, despite a difficult election year for the ANC, the government did not give in to the temptation of an expansionary fiscal policy. Instead, government spending excluding interest payments on debt fell by 1.3 pp of GDP to 23.9% of GDP. In particular, current payments, which include the wage bill and the consumption of goods and services, recorded growth of just 1% in nominal terms, against inflation of 5.9%. At the same time, social transfers and subsidies increased more sharply (+4.5% in nominal terms), but also less than inflation. They accounted for 38% of total public spending, a share that has remained stable over recent years.

From FY24 onwards, the DA's presence within the government, if sustained over time, should help it to meet its fiscal and debt trajectory targets, which have been exceeded many times in recent years. The National Treasury forecasts that the fiscal deficit should gradually narrow to below 4% of GDP in FY26. However, these forecasts do not include the partial take-over of Eskom's debt, which amounts to 0.9% of GDP in FY24 and 1.4% of GDP in FY25. If this is taken into account, as it is in the IMF forecasts published at the beginning of September 2024, the deficit should reach 6.2% of GDP in FY24, before rising to 6.5% in FY25.

In addition, there are numerous risks of fiscal slippage. During the election campaign, the ANC notably promised to turn the SRD grant into a universal basic income over the next two years.

CHALLENGING FISCAL CONSOLIDATION

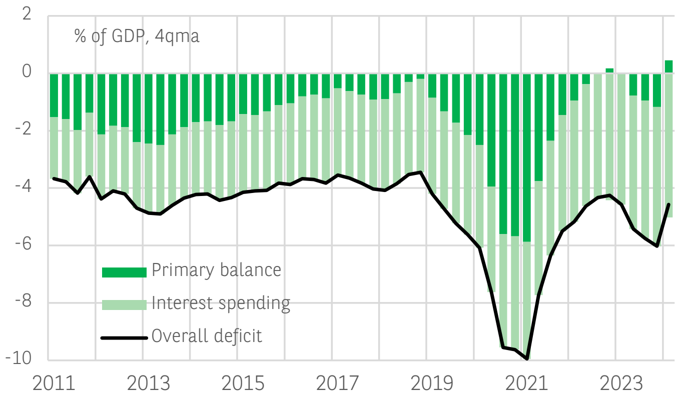

CHART 5 SOURCE: SARB, BNP PARIBAS

Such a promise requires additional sources of funding, which were not taken into account in the February 2024 budget. Furthermore, in mid-May 2024, President Ramaphosa signed a bill on the new national health insurance scheme into law. This bill, which is expected to create a public fund to cover healthcare costs, nevertheless has no designated funding and has been met with strong opposition from the DA. Together with the proposed universal basic income, both of these reforms could become bones of contention for the alliances within the GNU ahead of next year's budget, in February 2025.

The government will have a new financial resource over the next three fiscal years. Last June, the National Treasury reformed how profits accumulated over the years on its Gold and Foreign Exchange Contingency Reserve Account (GFECRA) at the SARB are managed. After several months of debate, it was ultimately decided that the GFECRA's unrealised profits (ZAR 524 billion) would be used to reduce the government's borrowing requirements and repay part of its debt early. To enable the Treasury to use its accumulated profits without selling reserve assets, the SARB will monetise part of the GFECRA profits, amounting to ZAR 150 billion (2% of GDP), which will be transferred to the Treasury. In order to mitigate the inflationary impact of monetisation, the SARB has authorised the country's commercial banks to increase their liquidity reserves above the regulatory minimum. As these excess reserves are remunerated at the repo rate, an additional ZAR 100 billion will be transferred from the GFECRA to another SARB account to pay the interest. The use of GFECRA profits will help to reduce the government's borrowing requirements by 1.4% of GDP in FY24 and 0.3% of GDP in each of the following two fiscal years.

The IMF estimates that the government's borrowing requirements should amount to 15.4% of GDP in 2024, before rising to 16.2% of GDP in 2025. Over this period, the government should cover its borrowing requirements without major difficulty, mainly by issuing domestic debt, but also, to a lesser extent, by issuing foreign currency debt and drawing on its liquidity reserves. However, with rising debt levels, the refinancing risk has increased in recent years.

Debt and contingent liabilities: a heavy burden to bear

Public debt will remain high in the coming years. Over the past decade, the government-debt-to-GDP ratio has slowly yet steadily risen, from 32% in FY10 to 57% in FY19 (*chart 6*). With the impact of the pandemic, this ratio jumped to 70% of GDP in FY20, and the weak recovery since 2021 has not enabled it to stabilise: it stood at 74.1% of GDP in March 2024. Despite the expected fiscal consolidation, public debt is set to continue rising, hitting 79% of GDP in FY26, and 84% of GDP in FY29, according to the IMF. The snowball effect on debt, generated by a higher borrowing rate than the nominal GDP growth rate, is the main reason for this. Over the past decade, interest payments on public debt have risen steadily, absorbing 23% of fiscal revenue in FY23, compared with just 15% in FY19 and 12% in FY15. Since mid-2023, the South African government has been refinancing at higher real interest rates as a result of the SARB's monetary tightening, the slowdown in inflation and the increase in the risk premium on government bonds. In 2023, the average yield on government bonds maturing in ten years or more hit its highest level in the past decade, at 11.6%, up 0.8 pp from 2022 and 1.8 pp from 2021 (*chart 7*). As a result, the spread between this yield and inflation hit a historically high level of 700 basis points in April-May 2024. From Q4 2024, the government's borrowing costs on the shortest maturities could fall thanks to the start of the SARB's monetary easing cycle. In addition, the government could continue to benefit from a recent fall in the sovereign risk premium following the formation of the GNU. However, a sustained fall in the sovereign risk premium will hinge on unity within the new government and on whether it is able to pursue the series of structural reforms and fiscal consolidation.

While the government's solvency has deteriorated, the sustainability of public debt is not yet a cause for concern, at least in the short term. In fact, the public debt profile is still satisfactory, and the refinancing risk is still low in the short term. In April 2024, only 11% of public debt was denominated in foreign currency, and this percentage has remained stable in recent years. The small share of foreign-currency-denominated debt greatly mitigates the impact of a depreciation of the rand on sovereign risk. In addition, the average maturity of public debt is comfortable, at 12.6 years, even though it has fallen since 2018, due to the government's strategy of reducing the cost of debt by relying more on short-maturity instruments. In addition, foreign investors' appetite for domestic bonds has held up despite the series of shocks in recent years. Indeed, although the share of foreign investors on the domestic government bond market fell from 37% in December 2019 to 25% in July 2024, in absolute terms, foreign investors increased their exposure to government bonds by ZAR 142 billion over the same period.

State-owned companies continue to weigh on public finances. The government's total contingent liabilities amounted to 16% of GDP in FY23. Nearly half of this amount was made up of guarantees on the debt of state-owned companies, Eskom in particular. On top of the debt relief process from which Eskom is currently benefiting, a new financial rescue of the state-owned electricity company cannot be ruled out, given its high level of debt (it is still expected to amount to 3% of GDP even after the final stage of the current debt relief, scheduled for FY25) and its poor performance. In the FY ending March 2024, despite an 18% increase in electricity prices, Eskom is expected

PUBLIC DEBT AND INTEREST PAYMENTS ARE RISING

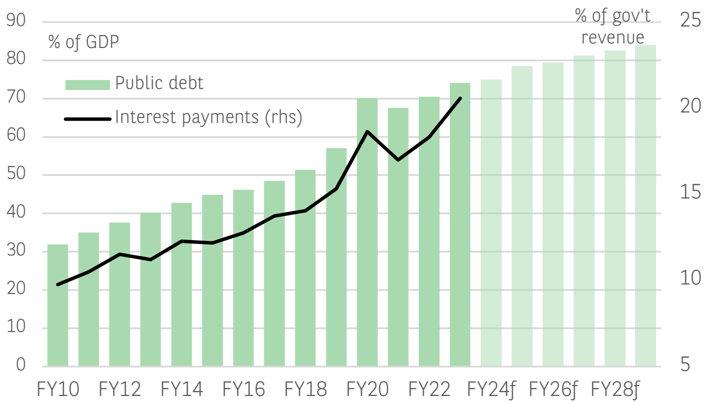

CHART 6 SOURCE: SARB, IMF, BNP PARIBAS

HIGHER BORROWING COSTS ACROSS ALL MATURITIES

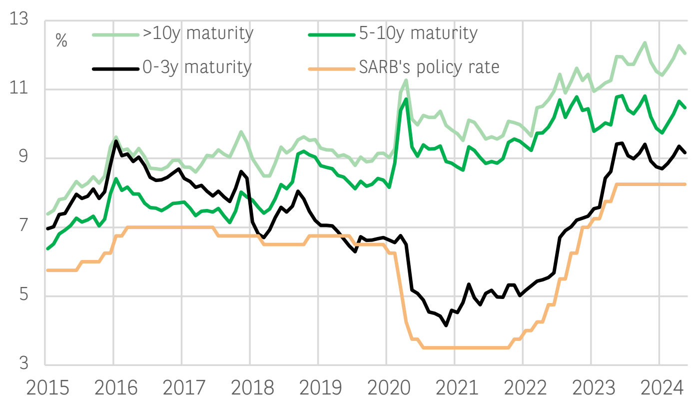

CHART 7 SOURCE: SARB, BNP PARIBAS

to record a further loss of 0.2% of GDP (ZAR 15 billion, compared with ZAR 23 billion in FY22). The company's profitability is undermined by increasingly high production costs, which are only partially reflected in the electricity price hikes set by the energy regulator (NERSA). At the end of August 2024, the government announced that the pricing methodology would soon be reformed in order to better reflect costs. State-owned companies other than Eskom are also making recurrent financial losses. However, the government's strategy of divesting itself of unprofitable businesses is being hampered by legal obstacles and the struggle to find private partners. In the case of state-owned South African Airways (SAA), an agreement with a private consortium for 51% of the company's shares fell through in March 2024 due to a disagreement over the value of the shares. No other agreement is expected in the immediate future.

In a nutshell, public finances have deteriorated against a backdrop of very weak economic growth, which has compounded the snowball effect of debt. On a positive note, the public debt profile strongly limits liquidity risk. However, reducing fiscal deficits, increasing the profitability of state-owned companies and pursuing reforms aimed at boosting the economic growth potential are all needed in order to broadly reduce sovereign risk. Accordingly, the stability of the GNU and its ability to govern will be key risk factors in the medium-to-long term.

EXTERNAL ACCOUNTS: THE CURRENT ACCOUNT OF AN EMERGING COUNTRY, THE FINANCIAL ACCOUNT OF A DEVELOPED COUNTRY

South Africa's external accounts are structurally a potential source of financial instability. On the one hand, as minerals and metals account for over 40% of goods exports, the current account balance is vulnerable to external economic and geopolitical shocks that affect commodity prices. On the other hand, over the past decade, the balance of payments has relied heavily on short-term sources of financing, which are highly volatile and dependent on international financial conditions and foreign investor sentiment towards emerging countries. Therefore, over the 2020-22 period, the financial account recorded significant capital outflows, resulting from successive shocks since the pandemic. Then, from the end of 2022 onwards, without a strong recovery in foreign capital inflows, the return to a current account deficit has contributed to maintaining strong pressure on the balance of payments. In the medium term, the country's ability to attract foreign capital and meet its external borrowing requirements will largely depend on the dynamics of fiscal consolidation and reforms.

A current account balance dependent on changing terms of trade

In 2023, despite weak growth, the current account deficit widened to 1.6% of GDP, compared with 0.4% in 2022. The trade balance surplus contracted sharply from 3.3% of GDP in 2022 to 1.4% in 2023 (*chart 8*). On the one hand, terms of trade, which had reached exceptionally high levels in 2021-22 on the back of the post-pandemic global recovery, moderated sharply in 2023. Export prices of South African commodities fell, while the price of oil imports (21% of imports) remained high. On the other hand, the volume of exports, up by just 3%, was severely constrained by power cuts and domestic infrastructure deficiencies. At the same time, the import penetration rate (i.e. the ratio of imports to domestic demand) rose in 2022 and 2023 to 33%, compared with an average of 27% over 2015-19.

The fall in the trade surplus was mitigated by smaller deficits in the income and services balances. Over the past decade, the income balance has shown a structural deficit, due to the local presence of large foreign groups, repatriating all or some of their profits, and the strong presence of non-resident investors on the domestic financial markets. However, with foreign investors withdrawing and economic activity declining, income paid to non-residents has fallen. In 2023, the income balance deficit narrowed to USD 7.4 billion, the lowest level in a decade. The services balance deficit also narrowed in 2023. However, since the pandemic, the services balance has moved into deficit due to the decline in activity in the tourism sector. In 2023, revenue from tourism increased for the third consecutive year, but remained 24% below its 2019 level.

CURRENT ACCOUNT BALANCE

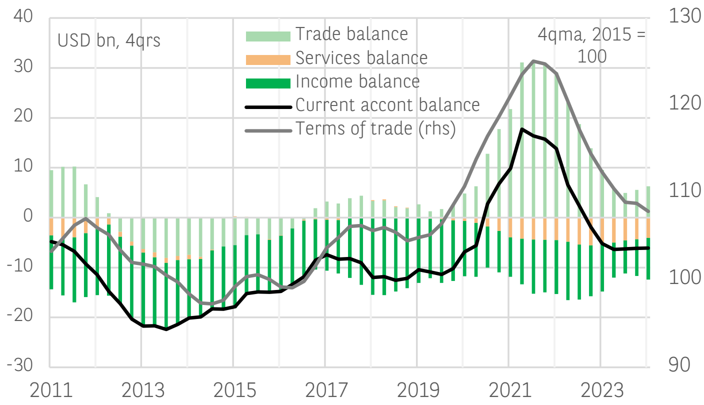

CHART 8

SOURCE: IMF, BNP PARIBAS

FINANCIAL ACCOUNT

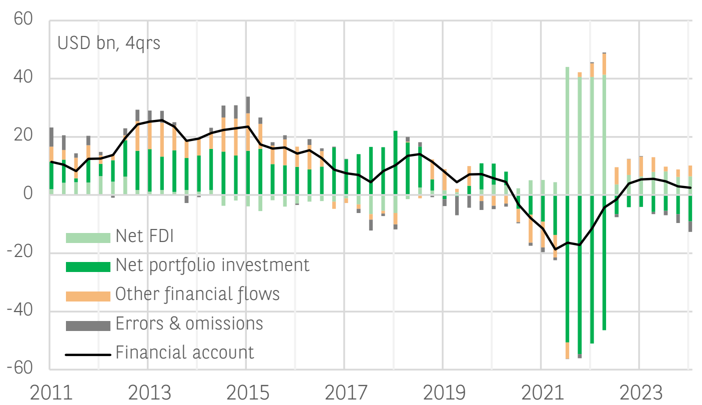

CHART 9

SOURCE: IMF, BNP PARIBAS

Heavy dependence on portfolio investments

South Africa's dependence on short-term foreign financing is a second vulnerability for the external accounts. During the 2010s, net foreign direct investment (FDI) inflows were negative most of the time and, when they were not, they accounted for just a small proportion of net capital inflows (*chart 9*). Instead, the country relied mainly on net portfolio investment inflows, which covered 90% of current account deficits on average over 2011-19. Access to this volatile source of funding was facilitated by the accommodative financial conditions at the time, as well as the liquidity of South African domestic markets and the high yields on local assets. As a result, the stock of portfolio investments has risen steadily: after peaking in 2017, it remained at a very high level over the following two years, standing at USD 249 billion (64% of GDP) in 2019.

The pandemic, the war in Ukraine combined with South Africa's neutral position, the global monetary tightening cycle and waning investor confidence have led to massive portfolio investment outflows since Q3 2020 (USD 72 billion cumulatively). These portfolio investment outflows have only been partially offset by the rise in net FDI inflows (1.5% of GDP over 2020-2023)[1].

After four years of net portfolio investment outflows, South Africa remains highly exposed to the risk of further foreign capital flight. At the end of 2023, short-term external liabilities (i.e. foreign capital that can leave the country quickly) still amounted to USD 211 billion. Despite the steady increase in the central bank's foreign exchange reserves since 2015, these foreign exchange reserves alone are not a sufficient buffer against external shocks. Indeed, at the end of 2023, short-term external liabilities, which include portfolio investments in equities and bonds as well as short-term external debt, still accounted for 342% of foreign exchange reserves, compared with 552% at the end of 2019 (*chart 10*).

SHORT-TERM EXTERNAL LIABILITIES

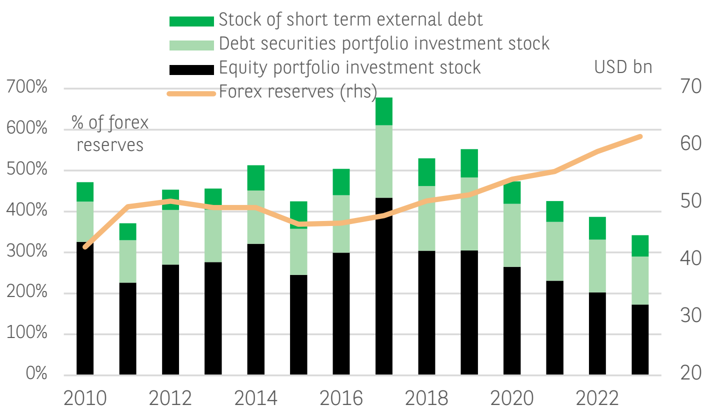

CHART 10 SOURCE: IMF, SARB, BNP PARIBAS

Exchange rate flexibility as the only adjustment variable

External borrowing requirements are set to increase over the next few years. On the one hand, the current account deficit is expected to widen to 2.5% of GDP on average over 2025-26. This will be due in particular to the normalisation of terms of trade, which should continue with the expected further fall in metal prices. On the other hand, external debt amortisation will be higher.

As far as sources of external financing are concerned, foreign capital flows will be strongly linked to the success or failure of the GNU and the pace of the structural reforms implemented. Since it was formed in mid-June 2024, the short-term signals have pointed to improved investor sentiment thus far. The South African rand (ZAR) appreciated by 8.4% between mid-June and the end of September 2024, while the average yield on government bonds with a maturity of ten years or more fell by 180 bp. However, any major disagreement between the ANC and the DA, leading to unprecedented political paralysis, could have a significant negative impact on foreign investor confidence and trigger further episodes of capital flight.

On a positive note, however, South Africa is benefiting from a number of factors that are mitigating the impact of shocks on external accounts and are helping to preserve the stock of foreign exchange reserves.

Firstly, thanks to the floating exchange rate regime, exchange rate flexibility makes it possible in theory to correct an overly sharp deterioration in the external accounts by acting as an adjustment variable. As a matter of fact, the South African rand has depreciated sharply since the pandemic, falling 22% against the US dollar between 2019 and 2023 (*chart 11*). It then stabilised over the first five months of 2024 and then appreciated following the formation of the GNU.

EXCHANGE RATE AND METAL PRICES

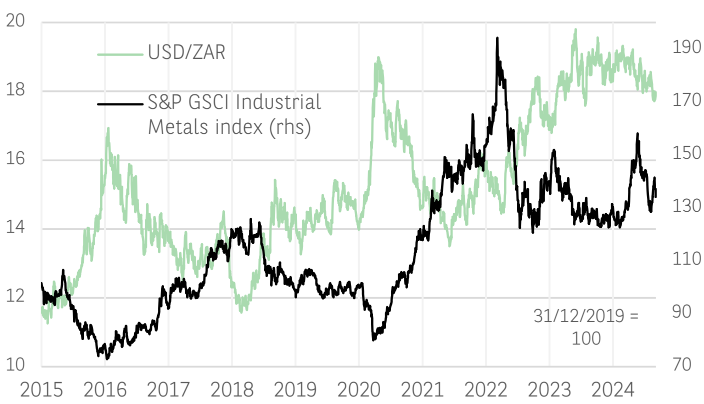

CHART 11 SOURCE: SARB, S&P, BNP PARIBAS

Secondly, the exposure of economic agents (mainly the government and commercial banks) to exchange rate risk is moderate. In Q4 2023, total external debt amounted to 41.1% of GDP (*chart 12*). However, foreign currency-denominated debt accounted for 57% of the total and was therefore moderate, at 23.3% of GDP. Furthermore, short-term debt only accounts for 20% of total external debt. South Africa also has a positive, albeit volatile, net international investment position (28% of GDP in Q4 2023). It mainly consists of short-term investments that can be easily repatriated if necessary.

1 Except for 2021, when Prosus acquired 45% of its South African parent company Naspers. This led to an accounting adjustment that resulted in substantial FDI inflows, offset by portfolio investment outflows of the same order of magnitude.

BANKING SECTOR'S MACROPRUDENTIAL RATIOS

		2019	2020	2021	2022	2023	2024*
	Capitalisation						
Capital adequacy ratio	%	16.5	16.2	17.6	17.7	17.4	16.3
Tier 1 capital adequacy ratio	%	13.4	13.1	14.6	15.0	15.0	14.0
Foreign loans to total loans	%	8.6	9.6	7.9	7.8	7.6	7.6
	Profitability						
Return on assets (ROA)	%	1.2	0.8	0.8	1.1	1.1	1.1
Return on equity (ROE)	%	15.3	10.1	10.6	14.9	14.8	15.0
Cost-to-income ratio	%	58.8	58.7	58.3	57.0	56.6	56.8
	Liquidity						
Liquid assets to total assets	%	11.0	12.1	13.3	13.9	14.6	14.2
	Assets' quality						
Ratio of non-performing loans	%	3.8	4.7	4.9	4.5	5.2	5.5

TABLE 1

* May or March.
SOURCE: SARB, BNP PARIBAS

In addition, prudential regulations on foreign assets held by local investors act as an automatic shock absorber. While capital controls for non-residents were completely abolished a long time ago, some remain for residents, although they have been progressively eased over the years. For example, local institutional investors (insurance, pension and savings funds) can invest up to 45% of their total assets abroad. FDI by South African companies is also limited to ZAR 5 billion. Should the ZAR depreciate, the value of foreign assets held automatically increases relative to domestic assets, thereby increasing the proportion of foreign assets in the total asset portfolio. The depreciation of the ZAR can therefore trigger a repatriation of capital.

Finally, South Africa benefits from a large domestic investor base and liquid domestic markets. Domestic investors can act as shock absorbers should there be capital flights by non-residents.

BANKING SECTOR: RESILIENCE AGAINST RISING RISK

South Africa has a large and sophisticated financial sector, dominated by banks, pension funds and insurers (whose assets account for 110%, 70% and 60% of GDP, respectively). The banking sector is well supervised, with adequate liquidity ratios and capital levels. However, the operating environment has deteriorated in recent years, due to weak economic activity, increased sovereign risk, heightened financial volatility and South Africa's inclusion on the Financial Action Task Force (FATF) grey list. Credit risk has hit unprecedented levels over the past decade and its impact on banks' capital and liquidity has started to materialise.

Banks are well prepared for the rising credit risk...

With the exception of a short, tentative recovery between mid-2022 and mid-2023, there has been negative growth in credit to the private sector since 2021. The share of banking credit to businesses and households has fallen significantly to 46% and 39% of total bank credit respectively, compared with 51% and 41%, respectively, in 2019.

However, since the end of 2022, banks have had to contend with rising credit risk in the private sector. Severe electricity shortages and weak economic growth in 2023 coincided with the SARB's monetary tightening cycle. The ratio of non-performing loans to gross loans,

MODERATE EXPOSURE TO CURRENCY RISK

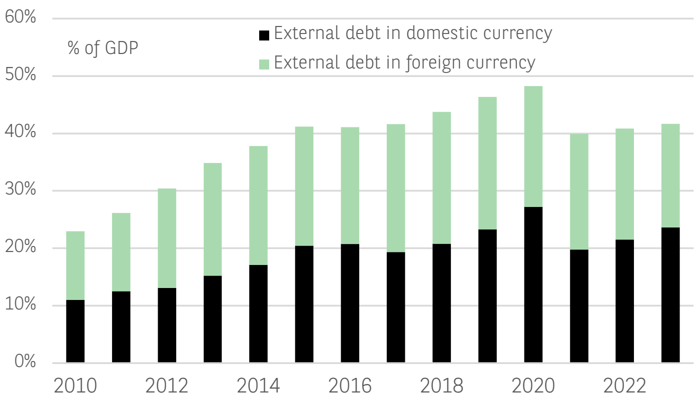

CHART 12

SOURCE: SARB, BNP PARIBAS

which had fallen to 4.5% in H1 2022, rose to 5.5% in May 2024, the highest level over the past decade. In addition, the non-performing loan ratio is significantly higher for households (10% mid-2023) than for businesses (3%).

That said, the banks are well prepared to absorb a deterioration in the quality of their assets. Over the past decade, South African banks have consistently had capital and liquidity ratios above the minimum requirements. Although these ratios began to deteriorate in H1 2024, they were still at historically high levels in March (*table 1*). The SARB, which oversees the banking sector, is recognised as an independent and credible authority, with standards in line with international conventions. In 2023, the stress test that it conducted showed that the six banks viewed as systemic (which, together, hold 92% of total banking assets) would withstand the various shock scenarios envisaged and would continue to post adequate capital ratios.

Household debt, on the other hand, is still high. In 2023, household debt amounted to 41% of GDP and 62% of disposable income.

Although these two ratios have been relatively stable since 2016, they are now slightly higher than their pre-pandemic levels. In addition, these aggregate ratios conceal major income inequalities between households.

… but there are governance shortcomings to monitor

In February 2023, the FATF placed South Africa on its grey list of countries that do not apply international standards for combating money laundering and terrorist financing. In June 2023, the European Union followed suit. These decisions have resulted in significant delays and additional transaction costs for South African banks, due to the strengthening of mandatory control measures. In order to get off the grey list, fourteen of the twenty-two actions required by the FATF still need to be implemented before January 2025. However, at the beginning of July 2024, the National Treasury acknowledged that achieving all of the objectives in time was unlikely. Although South Africa's top six banks enjoy a strong international reputation and numerous connections to the global financial systems, which has somewhat mitigated the impact of the FATF decision to date, remaining on the grey list in the long term could have detrimental consequences for the sector as a whole. In addition to the increase in transaction costs and its impact on banks' profitability, it could ultimately undermine investor confidence, reduce access to foreign currency financing and increase the cost of borrowing.

Another risk facing the South African banking sector is its growing exposure to sovereign risk. At the end of 2023, Treasury bonds and bills held by banks accounted for nearly 17% of total banking assets, compared with 13% at the end of 2019 and just 9% in 2015 (*chart 13*). Years of economic stagnation, banks' aversion to risk, the government's high borrowing requirements and the withdrawal of foreign investors from domestic markets are all factors that have led to banks' growing exposure to sovereign risk. The growing dependence of banks on Treasury bonds is crowding out credit to the private sector, as evidenced by the declining share of the private sector in total banking credit.

*****

The May 2024 general election brought South Africa to a crossroads. The entry of centre-right parties into a government led for thirty years by the ANC has inspired renewed confidence in the authorities' ability to pursue their ambitious programme of reforms and fiscal consolidation. However, in order to significantly raise the economic growth potential and contain the trajectory of public debt, many reforms are needed, and they will be slow to implement. The government of national unity will therefore have to prove that it is stable over time and overcome internal divisions in order to achieve this. Otherwise, there is a risk that the ANC's loss of an absolute majority in Parliament will slow down the reform process, with a detrimental effect on investor confidence, public finances and external accounts.

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BANKS' EXPOSURE TO SOVEREIGN RISK

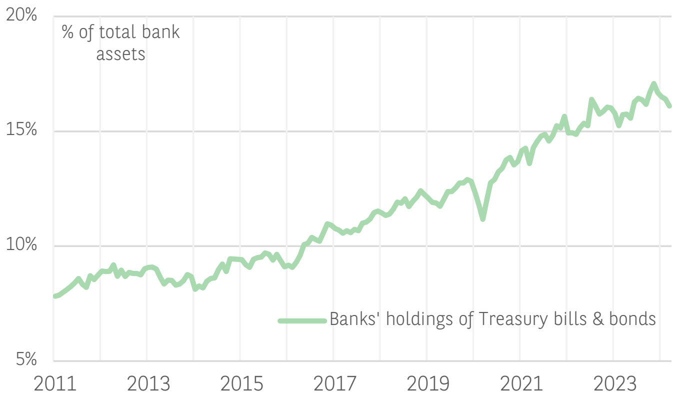

CHART 13 SOURCE: SARB, BNP PARIBAS

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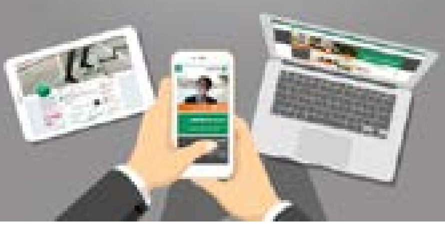

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