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A FRAGILE ECONOMIC RECOVERY

Perrine Guerin

After an unprecedented contraction in activity in 2020, the strong rebound in 2021 did not allow South Africa to return to its pre-crisis level of GDP contrary to most emerging economies. In 2022, activity should remain subdued and growth below 2% in the medium term. The economic outlook remains largely constrained by the need for fiscal consolidation in order to contain the high risk of debt distress, the tense socio-political climate, and structurally by strong infrastructure constraints, first of which the electricity supply. The shock induced by the conflict in Ukraine is also exerting significant pressures that could make fiscal consolidation efforts difficult. The acceleration of inflation is fueling socio-economic difficulties and the demands of the population vis-à-vis the authorities (request for subsidies, expectations regarding wage increases, etc.). However, a potential budgetary slippage raises fears of an unsustainable debt increase while concerns about its level, dynamics and cost are already present. Although the rise in commodity prices should allow for fiscal and exports revenues, the economic environment entails significant downside risk factors. The economic recovery is therefore subject to a number of uncertainties and the authorities' commitment to the continuation of the reform process will be key in strengthening investor confidence, overcoming obstacles to growth and improving the budgetary balance.

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ECONOMIC RESEARCH

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A FRAGILE ECONOMIC RECOVERY

After an unprecedented contraction in activity in 2020, the strong rebound in 2021 did not allow South Africa to return to its pre-crisis level of GDP contrary to most emerging economies. In 2022, activity should remain subdued and growth below 2% in the medium term. The economic outlook remains largely constrained by the need for fiscal consolidation in order to contain the high risk of debt distress, the tense socio-political climate, and structurally by strong infrastructure constraints, first of which the electricity supply. The shock induced by the conflict in Ukraine is also exerting significant pressures that could make fiscal consolidation efforts difficult. The acceleration of inflation is fueling socio-economic difficulties and the demands of the population vis-à-vis the authorities (request for subsidies, expectations regarding wage increases, etc.). However, a potential budgetary slippage raises fears of an unsustainable debt increase while concerns about its level, dynamics and cost are already present. Although the rise in commodity prices should allow for fiscal and exports revenues, the economic environment entails significant downside risk factors. The economic recovery is therefore subject to a number of uncertainties and the authorities' commitment to the continuation of the reform process will be key in strengthening investor confidence, overcoming obstacles to growth and improving the budgetary balance.

A feeble economic outlook

Before the pandemic, SA was marked by sluggish economic growth. The pandemic further weighed on SA's overall country risk profile by exacerbating poverty and inequality and weakening public finances. The pandemic shock in 2020 was unprecedented (*see Chart 1*), and although economic growth rebounded in 2021 (+4.6%), the South African economy had not returned to pre-Covid levels of activity by the end of the year. SA's recovery has been fragile, and its growth potential remains very much hampered by structural constraints.

Enduring economic impediments and weak potential output

After successful years of democratisation, economic growth and falling poverty rates, the years of Zuma's presidency (2009-2018) turned a corner. The apparent resilience after the Global Financial Crisis (GFC) has changed into deep stagnation. Economic growth barely averaged +1% per year 2015/19, performing below its already very low potential as well as below the population's average annual growth rate (+1.5% in 2015/19). Accordingly, income per capita decreased and exacerbated the already significantly high levels of poverty and extreme inequality.

Long-lasting political and structural constraints have strongly reined in economic activity. Poor infrastructures have constrained productivity and economic growth for years, and the importance of the mining sector has continuously lost ground to the tertiary sector. Lack of investment and SOE's deficiencies in their operational performance have led to increasing energy, transport and communication bottlenecks. The investment ratio fell from 21% of GDP in 2007 to 17% in 2019. This was mostly driven by the decline in private investment (from 15% of GDP in 2007 to 12% in 2019). Corruption scandals, shortages of skills, and labour market rigidity have weakened private investors' confidence and the overall business climate even though quality of the country's institutions remains better than that of its regional peers. Mistrust toward the political class has increased in a context of more acute and concentrated control of resources; obstacles to state-owned enterprises' (SOEs') productivity development particularly weighed on their competitiveness and performances. The tightening of market regulations, rising power of dominant players and SOEs in strategic sectors are identified as the key factors disincentivizing investment and contributing to the economy's lack of momentum.

In 2018, the country's challenges have persisted along with Cyril Ramaphosa's accession to government. Favourable conditions for reforms have started to emerge, but they are still slow to take place.

SLUGGISH ECONOMIC GROWTH

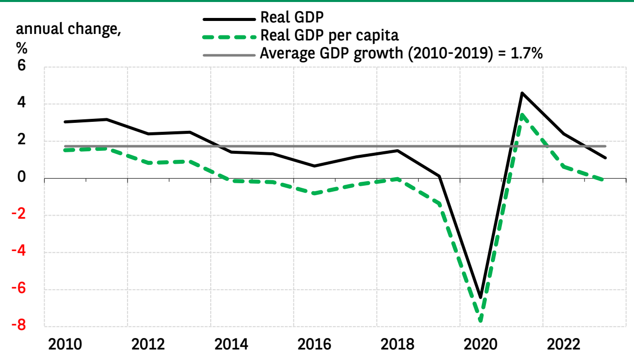


CHART 1 SOURCE: STATISTICS SOUTH AFRICA, IMF, BNP PARIBAS

REAL GDP GROWTH BY SECTOR

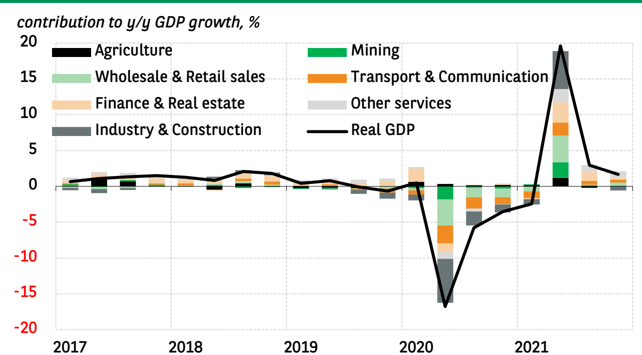


CHART 2 SOURCE: STATISTICS SOUTH AFRICA, BNP PARIBAS

A severe shock

The pandemic crisis emerged in this context of already weakening economic fundamentals. The direct effects of the decline in global demand and the national lockdown led to an unprecedented -6.4% contraction in GDP in 2020.

The virus started to spread across the country from March 2020 and led the authorities to impose a strict lockdown while declaring a national state of disaster. On the back of drastic measures and restrictions, only essential services and businesses could operate. Household demand obviously took a hit, falling by -20% y/y in Q2 2020 while shortages of input and frequent power outages weighed on supply chains. The shock on the external sector was equally strong given the sharp decrease in global demand; SA's exports fell by more than -30% y/y in Q2 2020.

The economy caught up a bit in H2 2020 and H1 2021 with the gradual easing of restrictions (*Chart 3*), but renewed waves of infections (*Chart 4*) resulted in lastingly subdued demand. The latest wave of the Omicron variant in late 2021, in particular led the government to impose restrictions in the fourth quarter of 2021. To date, approximately 3.7 million people have been infected by the virus (6.5% of the total population), that resulted in about 100 000 deaths. SA is one of the countries in the region with the highest rate of vaccination. However, its vaccination rate remains low with only 35% of the population (44% of adults) having received one injection.

The recovery in the first half of 2021 was also held back by rioting over the summer. On a sectoral basis, the recovery remained uneven: mining production has recovered to the pre-pandemic level, supported in part by sharply higher commodity prices while sectors such as construction, transport and trade still lag. In fact, job creation has remained weak, and these are labour intensive sectors. Unlike most emerging countries, the South African economy had not returned to its pre-Covid level of activity at end 2021.

A fragile recovery

In 2022, the country faces the new shock of the Ukraine war in the context of an incomplete and fragile recovery. The pace of recovery is likely to slow. We consider that the export component should benefit from the commodity price cycle. But, in volume terms, exports are expected to be subdued as growth projections for SA's major trading partners have been revised downward.

The shock on domestic demand is expected to be significant. Besides dampening overall confidence, the war in Ukraine has fuelled upward pressure on SA's inflation, which is expected to reduce households' purchasing power. Although SA has few direct links with Ukraine and Russia (0.8% of total imports in 2020), its status as a net importer of hydrocarbons and cereals exposes it to the general increase in prices and disruptions in supply chains. The magnitude of the rise in inflation will depend on second-round effects and the evolution of the conflict.

In the meantime, we also keep an eye on the Covid19 situation: the national state of disaster and bulk of restrictions were lifted in the beginning of April, but the epidemic risk has not ended.

In the medium term, SA's economic growth potential is expected to remain low, constrained by the structural slowdown in productivity growth and the obstacles for investment. Moreover, the inefficient SOEs (over 700 public businesses operating domestically) will keep acting as a drag on growth due to their impact on public finances (absorption of fiscal resources, net negative cash flow) and the quality of infrastructure (absorption of fiscal resources at the expense of public investment).

SOEs, which are concentrated in key industries such as power (Eskom) and transportation (Transnet, South African Airways) are in fact at the heart of SA's low economic growth. In particular, major power outages endured by corporates and households and the continued deterioration in Eskom's finances and production capacity are the cause of significant operating losses since 2019.

A SEVERE GDP SHOCK

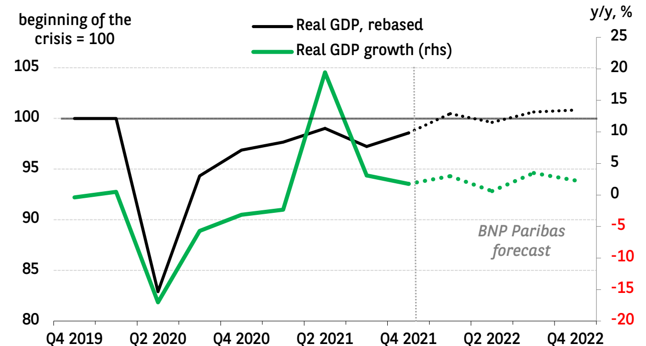
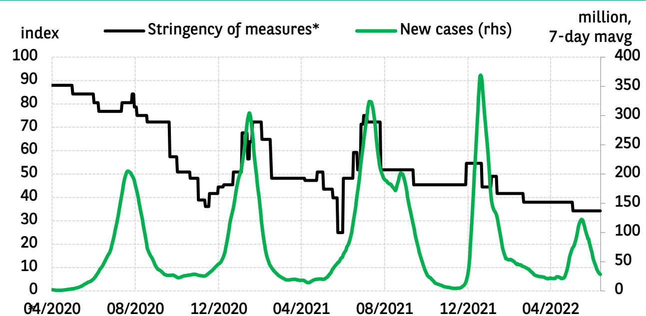


CHART 3 SOURCE: STATISTICS SOUTH AFRICA, IMF, BNP PARIBAS

IMPROVING THE COVID-19 SITUATION



** Composite measure based on nine indicators including school/workplace closures, and travel bans, rescaled to a value rom 0 to 100 (100 = strictest measures)*

CHART 4 SOURCE: OUR WOLD IN DATA, BNP PARIBAS

Over the medium term, real GDP growth should barely reach 2% per year, even in a relatively positive scenario where the government succeeds in strengthening its public accounts, implementing reforms aimed at supporting total factor productivity and lifting structural constraints on economic activity.

A strained socio-political climate

South Africa's legacy is still very strong with a society characterised by extreme inequality in income and employment opportunities as well as a very high poverty rate. The situation has worsened over the past few years and deteriorated greatly since the Covid shock. The risk of social instability is high, as is illustrated by the violent unrest of July 2021. The socio-political climate is also likely to heat up ahead of the 2024 general elections. Until then, the focus will be on the ANC summit scheduled for December 2022 that will publicize the party's agenda and goals.

Increased frustrations and resentment

The South African society is characterised by a strong legacy of inequality, very high levels of poverty and unemployment that altogetherfuel social frustrations. In spite of the path taken in the late 1990s toward successful democratisation, years of GDP growth have not translated into a rise in GDP per capita, and the society has remained one of the

most unequal in the world[1]. Inequality of opportunities is considered to account for 30% of income inequality. As a legacy of apartheid[2], racial divisions (with black people accounting for 80% of the population) are still at the root of the deep fractures within the population. The efforts implemented for the redistribution of wealth have largely failed to reduce inequality.

The fractures within the population were widened by the coronavirus crisis and exacerbated the already tense social climate. The very destructive civil unrest that arose in July 2021 (said to be the most violent since the end of apartheid) cannot be considered to be just an isolated event.

The average disposable income fell drastically in 2020 as 1.8 million of jobs were destroyed. The unemployment rate reached a record high of 35.3% in Q4 2021 (*Chart 5*) and appears disproportionately concentrated amongst youth and women. The 2020 recession has seemingly had durable effects on the labor market with a significant number of people having exited the labour market (the participation rate fell to 56.3% in Q4 2021 from 59.8% in Q4 2019). Over one million of people were pushed into poverty as compared to 2019 and inequality has reached unprecedented levels with highly skewed income distribution towards the richest: the top 10% of the population held 70% of the country's wealth in 2021 (against 62% a decade ago).

The confluence of such factors increases social frustration, and all the more so as broad-based price increases are expected to weigh on South Africans purchasing power. Mineworkers' unions are currently on strike and public sector wage negotiations are underway. The outcome of negotiations may create some dissatisfaction even if the government reneges on its objective of a wage freeze and offers a slightly higher nominal wage increase than assumed in the budget. We therefore expect discontent to grow in the coming months.

The increase of civil protests could exert strong pressure on growth with the risks being twofold. First, they would bring the risk of disruptions in key infrastructures and supply chains. Second, they would deter investment by weakening private sector confidence. The rioting that erupted in July caused damage costing USD 1.7 bn.

The fragilized ruling party

Adding to the already tense social climate, the ruling ANC faces increasing internal divisions that hinder its political leadership, coordination and efficiency. Elected in 2018 on his promise of addressing the endemic corruption that culminated during President Zuma's era, Cyril Ramaphosa has seen his government's popularity decline since it took office. The ANC's popularity currently appears to be at its lowest level since it came to power in 1994, as is reflected in the gradual decrease in its share of the vote in the past few elections (*Chart 6*). The party received only 46% of total votes in the latest local elections, falling below 50% for the first time since it came to power (1994).

The party's leadership election in December 2022 will be decisive to set up a clear strategy as well as party unity for the next presidential elections in 2024. This is a binding condition (although not necessarily sufficient) to accelerate structural reform in South Africa.

SKYROCKETING UNEMPLOYMENT RATE

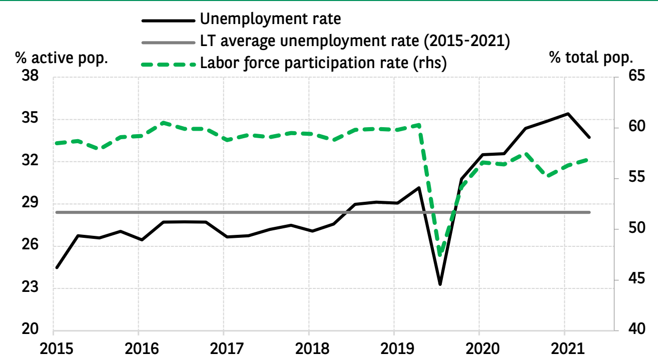


CHART 5 SOURCE: STATISTICS SOUTH AFRICA, IMF, BNP PARIBAS

FALLING SUPPORT FOR THE RULING ANC

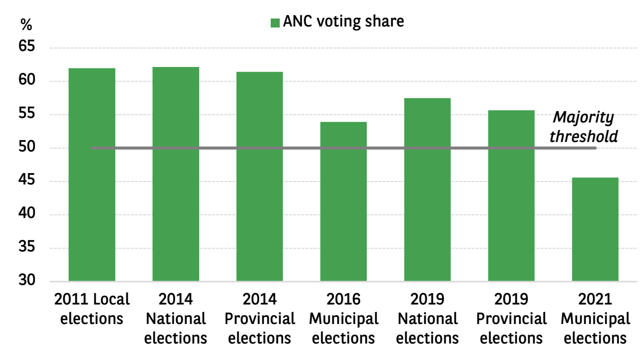


CHART 6 SOURCE: ELECTORAL COMMISSION OF SOUTH AFRICA, BNP PARIBAS

Public finances: Favourable cyclical factors but still worrying medium-term prospects

SA's public finances have deteriorated dramatically in recent years against a backdrop of anaemic growth and continued increases in public spending.

A weak fiscal situation exacerbated by the pandemic

The stalling economic conditions have driven up the fiscal deficit, which widened from -4.1% of GDP in FY 2014/15 to -6.1% in FY 2019/20 (*Chart 7*). Similarly, the public debt-to-GDP ratio ballooned more than 20 percentage points over the same period. While large budgeted expenditures accounted for the largest driver of such dynamic, low real GDP growth and inflation and weak control over SOEs also explained this deterioration.

The arrival of the Cyril Ramaphosa government in 2018 fuelled hopes for fiscal adjustment and a rebalancing of the budget. However, the expectations for such a turnaround were quickly disappointed. Given the rigidity of expenditures and the need to improve social protection, the authorities emphasised revenue expansion measures. Despite revenue-enhancing fiscal measures (VAT increase, tax bracket adjustment, etc.), the situation has continued to deteriorate particularly with a si-

1 According to the latest available data (2017), South Africa's Gini coefficient is amongst the world's highest at 0.62.
2 Institutional racial segregation regime in place from 1948 to 1990, characterized by an authoritarian political culture dominated by the white population minority.

gnificant increase in the public sector wage bill. It grew at a slower pace than during Zuma's presidential mandate but still posted an average annual increase of about more than 2% in real terms in 2018/19 and 2019/20, while the cost of debt service also rose by an annual average of more than +12%. Besides, in 2019, the rescue plan for Eskom, the state-owned power company, for nearly ZAR (South-African rand) 60 bn (1% of GDP) further widened the deficit

Fiscal slippages have increased over the past three years. In 2020, faced with an unprecedented economic recession, the authorities maintained and extended their expansionist economic policy with a vast stimulus plan. Estimated to cost ZAR 500 bn (USD 27 bn, or 10% of GDP), the measures included major support for companies (via tax cuts and state-backed loans) and households (temporary revenue support through welfare allowances) and a system of bank loans with state-backed guarantees.

The deficit thus widened to 9.9% of GDP in FY 2020/21 and contingent liabilities reached 20.3% of GDP (vs. 15% on average over the prior 5 fiscal years). Against this backdrop, the government has had to find new sources of funding and limit the rise in the cost of funding. In this regard, it has relied more extensively on drawing on cash reserves, on support from official creditors via low-interest credit lines (notably the IMF RFI of USD 4.3 bn) and, for the remainder, a greater use of government bond issues on the domestic market (nearly 60% of total financing for 2020/21).

Optimistic budget forecasts to be toned down in

In the context of recovery in 2021, the deficit was reduced, but the public debt ratio continued to rise. For the coming fiscal year, the government released more favourable budget forecasts at the end of February than those published in late 2021. However, this optimism was mainly fuelled by cyclical factors, while structural vulnerabilities persist.

First, the budget is based on relatively optimistic projections of real GDP growth, of 1.9% in FY 2022/23 and 1.7% in FY 2023/24. Indeed, the budget was elaborated before the outbreak of the war in Ukraine, and we anticipate economic growth to be slower (+1.5% in FY2022/23).

The Treasury does not foresee any deficit reduction in fiscal year 2022-2023 (year ending in March 2023), with a deficit of 6% of GDP compared with the forecast of 5.5% in FY2021/2022 despite the rise in prices of mining commodities that should boost fiscal revenue. However, the government is not planning to raise fuel taxes since it does not want to aggravate the impact of the increase in retail pump prices.

On the spending side, the government maintained its proposal to control current expenditures with a 4% increase over the previous year's level. This reflects an increase in social welfare programmes and the extension of the one-time welfare allowance (ZAR 350 per person) set up during the pandemic. For the moment, this allowance has been extended to March 2023, with its total cost estimated to be ZAR 4 bn (0.7% of GDP). The strategy to consolidate spending is primarily to control public sector wages (which account for nearly 35% of total current expenditures) and avoid additional transfers to support state-owned companies. Containing those expenditures is key as the cost of servicing debt remains the most rapidly rising expense (+12% a year on average in FY 2022/23 and FY 2023/24), far outpacing the expected nominal GDP growth rate.

Worrying debt dynamics and gradual increase in refinancing risk

Despite rising inflation, government debt is projected to reach more than 75% of GDP. Such a heavy debt burden will be hard to stabilise despite the moderate primary fiscal deficit (excluding interest charges), and even forecasts calling for a return to a balanced budget as of FY 2023/2024.

The refinancing risk is moderate in the short term, notably mitigated by the structure of the debt: average maturity is 12 years, only 10% of total debt is denominated in FX and the share of debt in local currency

CONTINUOUS DETERIORATION OF THE BUDGET BALANCE

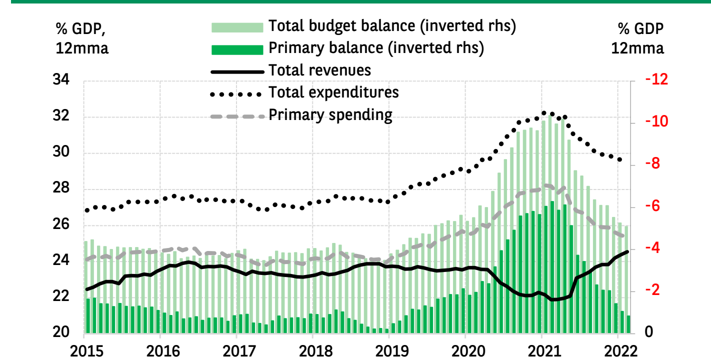


CHART 7 SOURCE: STATISTICS SOUTH AFRICA, BNP PARIBAS

ANNUAL CHANGE IN MAIN BUDGET ITEMS

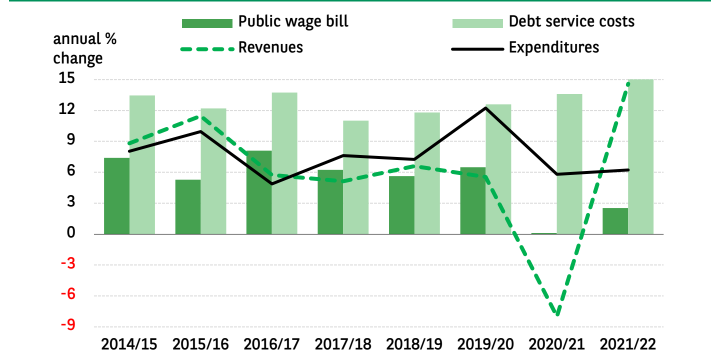


CHART 8 SOURCE: NATIONAL TREASURY, BNP PARIBAS

FISCAL FINANCING TABLE

	FY 2020/21	FY 2021/22	FY 2022/23	FY 2023/24	FY 2024/25
1- Gross funding requirements (a+b)	-11.1	-5.5	-6.0	-5.6	-5.2
a. Budget deficit	-9.9	-4.7	-4.8	-3.8	-3.5
b. Debt redemptions	-1.2	-0.9	-1.2	-1.8	-1.7
2- Gross debt issuance (c+d)	12.8	4.8	4.7	5.3	5.0
c. Domestic	11.1	3.7	4.1	4.6	4.2
Short-term (net)	1.7	-0.1	0.0	0.5	0.4
Long-term	9.4	3.8	4.1	4.1	3.8
d. Foreign	1.7	1.1	0.6	0.7	0.7
3- Cash balances	-1.7	0.7	1.3	0.3	0.2
4- Funding (2+3)	11.1	5.5	6.0	5.6	5.2

TABLE 1 SOURCE: NATIONAL TREASURY, BNP PARIBAS

held by non-residents is 28% (down from nearly 38% at end-2018) (*Chart 9*). Nonetheless, fiscal financing needs will approach 20% of GDP in FY 2022/23, and bond market conditions and dynamics are rather unfavourable. The country will still benefit from the support of multilateral creditors as is exemplified by the USD 750 million loan granted by the World Bank in early 2022. Nevertheless, SA has traditionally not resorted to such institutions and reliance on such concessional creditors should remain very limited in time and extent.

To cover financing needs, the authorities plan to resort mainly to the domestic bond market. This will finance 78% of total funding in FY2022/23 while drawing on deposit and cash reserves will account for about 22% of the total.

On the domestic bond market, the yield curve is higher than before the pandemic, which indicates higher borrowing costs across all maturities, and it has steepened with short-term yields dropping more than the decline of long-term yields in 2020. The yield curve has since remained particularly steep (*Chart 10*). This increasingly poses a trade-off for the government when it covers its financing needs as it has to arbitrate between containing the cost of public debt (by choosing short-term maturities) and containing rollover risk (by keeping maturities long-term as much as possible).

In the meantime, credit spreads for SA's foreign currency denominated debt have risen sharply and remain well above their level prior to the outbreak. SA's latest Eurobond issuance on April 12 has shown that market conditions have markedly deteriorated.

The rising cost of domestic and external financing and the growing burden of interest payments in the national budget is at the core of the increase in sovereign risk.

Refinancing risk might therefore rise gradually in the medium term. The wide gap between real interest rates and GDP growth is fuelling a negative snowball effect, which may deteriorate further in the short term (*Chart 11*). Interest payments already increased from around 9% of revenue after the financial crisis in 2010 to over 18% of revenue in 2021, and they are likely to keep rising as monetary policy is being tightened.

Prevailing challenges

In addition to the threats related to the conflict in Ukraine, the government's fiscal consolidation plans continue to face intense pressure on expenditures. In this respect, we can identify three aspects that could thwart fiscal consolidation and prevent the authorities from reaching their objective to stabilize debt by 2024/25.

First, the local population is increasingly dissatisfied with higher prices. Given the pressures created by income inequality and historically high unemployment, the one-time subsidy introduced in 2020 may become permanent and other subsidies may be implemented as well. For instance, after deciding not to increase fuel taxes in the budget, the government has decided to reduce the fuel tax (-40%) from the beginning of April to help the population to cope with the gas price increase. Initially implemented for two months, this measure was recently extended until August. The impact on tax revenues was supposed to be offset by the sale of strategic reserves but the extension of this subsidy will ultimately weigh on the budget: its cost is estimated at USD 288 Mns. This illustrates the population's current pressure on the authorities and their propensity to deploy subsidies.

Second, the current environment could force the government to scale back its plans to bring the public sector wage bill back under control.

GOVERNMENT BONDHOLDERS

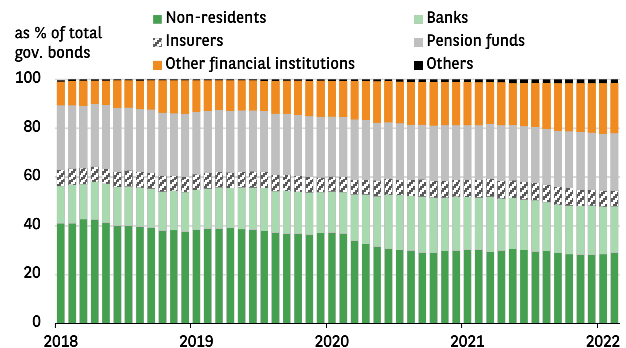


CHART 9 SOURCE: NATIONAL TREASURY, BNP PARIBAS

YIELD CURVE HAS STEEPENED

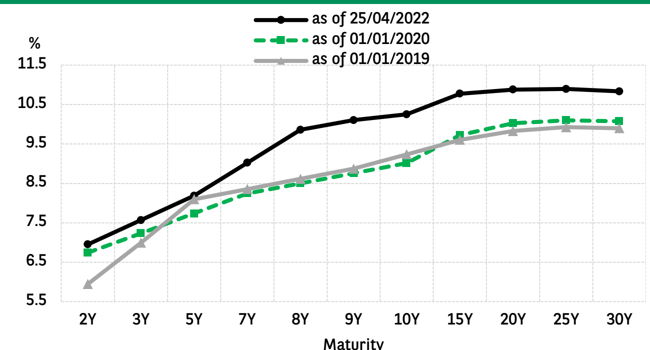


CHART 10 SOURCE: BLOOMBERG, BNP PARIBAS

Unions are asking the government for an annual nominal wage increase of nearly 10% (which corresponds to the inflation rate plus 2 percentage points) compared with a wage increase of just over 2.6% provided in the FY2022/23 budget. The latest news seem to indicate that the government will concede to a nominal salary increase greater than its budget assumption (+4.5% *a priori*). The final outcome of the negotiations will be decisive but the increase demanded by the unions would require additional measures to contain spending and/or reduce staff.

The credibility and execution of South Africa's fiscal framework will partly depend on the government's ability to limit unexpected expenditures related SOEs and contingent liabilities, which have contributed significantly to the government's rising debt burden. The liabilities of state-owned companies create a major fiscal burden. State-backed guarantees for SOE loans amount to more than 10% of GDP. About 60% of these guarantees is held by Eskom, whose debt takeover would represent ZAR 330 bn (USD 25.8 bn). The decision to restructure SOE debt has been constantly delayed, and the 9.6% increase in the cost of electricity in FY2022/23, which is well below the 20.5% requested, will not be sufficient to reduce Eskom's financial hardships.

South Africa's fiscal prospects remain extremely fragile. In the short term, the temporary revenue growth resulting from higher prices of exported commodities could be offset by the impact of weaker-than-

expected economic growth and fiscal adjustments. In the medium term, the crowding-out effect of fiscal imbalances on investment spending is likely to persist.

Monetary policy tightening and increased financial volatility

Following months of disinflationary pressures and policy accommodation, the central bank (SARB, South Africa Reserve Bank) started to tighten its policy rate in November 2021 in the context of accelerating inflation. In the coming months, the pace of normalisation will depend on how the authorities define the optimal trade-off between supporting economic recovery while addressing the surge in inflation.

Ample monetary easing during the crisis

Consumer price inflation (CPI) reached a historic low during the pandemic, falling from 4.5% y/y in February 2020 to 2.1% in May 2020 (*Chart 12*). Overall, in 2020, disinflationary pressures from falling demand and low oil prices more than offset the effect of the weak ZAR with average CPI contained at 3.2%. The SARB implemented a very accommodative monetary policy. By lowering its main interest rate by 270bps (*Chart 13*) without jeopardizing its inflation target within 3% to 6% inflation range.

Meanwhile, the SARB maintained sufficient liquidity within the financial system and supported borrowers facing falling earnings. The rather limited transmission mechanism of monetary policy (i.e. impact of interest rates on real spending) however limited the effect of support measures on domestic demand. Credit to the private sector grew by only 3.6% in 2020 and 2.6% in 2021.

Price surge and monetary policy normalisation

In 2021, global economic activity showed stronger momentum with production failing to keep up with the pace of increasing demand. Price pressures increased both domestically and internationally. In SA, CPI rose from +2.9% in February 2021 to +6.1% in March (from 3.1% for core inflation). Higher inflation has been driven by the significant increase in the transport component, which represents nearly 15% of the reference basket of goods and reflects the increase in energy prices. As a result, the SARB shifted to a more restrictive monetary policy aimed at safeguarding its mandate of price stability. It proceeded to three consecutive interest rate hikes of 25bps in November 2021, January 2022 and March 2022. Stepping up efforts to fight inflation pressures, the SARB's last committee increased the benchmark rate by 50bps in May. The key interest rate currently stands at 4.75%, and financial conditions are still accommodative with real interest rates still being negative.

Monetary conditions could tighten further in the coming months. Already present through the impact of the global recovery via higher energy prices, inflation pressures resulting from the conflict in Ukraine and supply chain disruptions have begun to spread to other items such as food (accounting for about 30% of households' spending). Inflation could also rise further on the back of cost pressures stemming from higher administered prices (*cf.* via efforts to put Eskom on a financially sustainable path with tariff increase). Consequently, we have drastically revised our inflation forecasts: We expect the inflation rate to be above the upper end of the 3%-6% target range in 2022, (averaging 6.5%) and 4.5% in 2023.

Monetary policy tightening is therefore expected to continue in the short term as the SARB wants to keep inflation expectations well anchored.

PERILLOUS DEBT TRAJECTORY

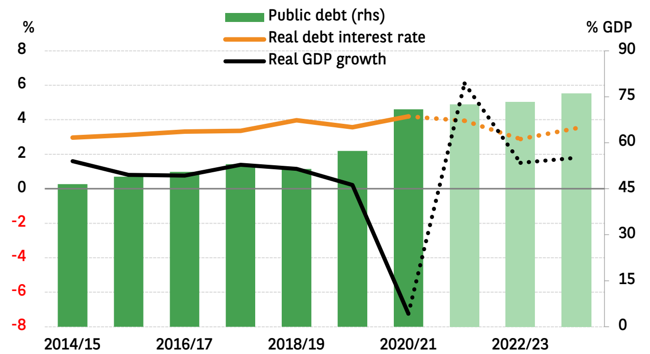


CHART 11 SOURCE: NATIONAL TREASURY, BNP PARIBAS

EXCHANGE RATE AND INFLATION

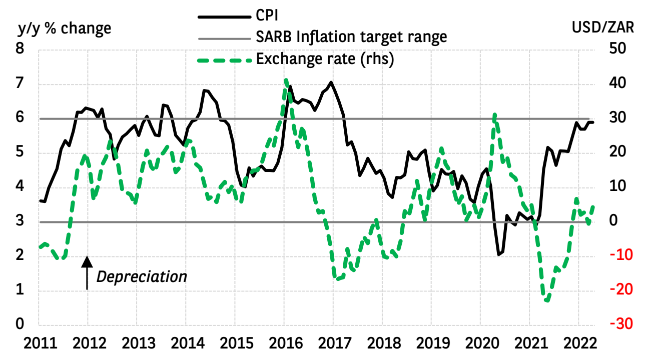


CHART 12 SOURCE: STATISTICS SOUTH AFRICA, RESERVE BANK, BNP PARIBAS

INFLATION AND MONETARY POLICY

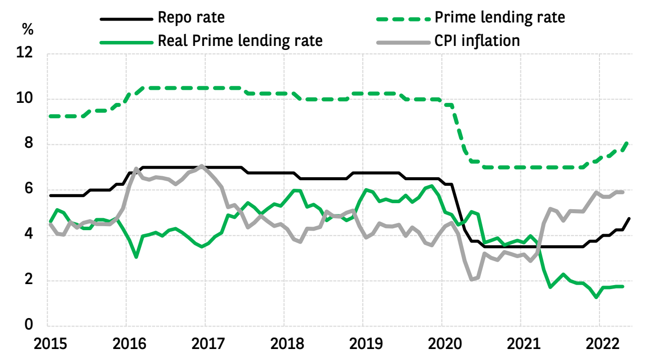


CHART 13 SOURCE: SOUTH AFRICAN RESERVE BANK, BNP PARIBAS

Nevertheless, as mentioned earlier the economic recovery is fragile (very high unemployment, high risk of civil unrest and indirect effects of the conflict in Ukraine). The authorities therefore face a trade-off between addressing the price surge at the risk of curbing economic activity or keeping a cautious approach to favour growth.

In addition, the increase in inflation is fuelled by supply shock. On the other hand, the SARB also needs to be cautious given the outlook for public finances and the risk of new bouts of stress in the currency and financial markets.

External accounts under pressure

SA was hit hard by the overall emerging market sell-off episode that occurred during the pandemic crisis. The country is indeed particularly vulnerable to market sentiment and volatility due to its reliance on commodity exports (mining and precious metal products account for more than 20% of total exports) and short-term sources of foreign financing (portfolio investments and derivatives).

With the pandemic crisis, weakening market sentiment and foreign capital outflows resulted in sharp corrections in almost all asset classes. The currency depreciated sharply, losing about 20% between end-2019 and June 2020. In the equity market, the Johannesburg Stock Exchange Index had lost over 15% y/y between end-2019 and June 2020. The government bond market also tumbled with long-term government bond yields soaring to a historical high in April 2020 (11.3%) (*Chart 14*).

The situation has stabilized since mid-2020: the ZAR regained 10% of its value, and the equity market posted a 35% gain by the end of 2021. Government bond yields have also narrowed, although they remain higher than their pre-pandemic levels.

Current account balance supported by cyclical factors

Over the past few years, SA had a significantly large current account deficit averaging -3% of GDP (2015-2019). SA's current account deficit was mainly driven by a trade deficit (dominated by exports of metals and minerals and imports of fuels) and a negative income balance (stemming from increasing interest payments).

The current account balance has improved recently (*Chart 15*). In 2020, it turned positive (+2.2% of GDP) on the back of lower imports and posted an even larger surplus in 2021 (+3.5% of GDP) thanks to higher commodity prices boosting revenue from exports. The trade balance registered a surplus of nearly USD 18 bn (vs. USD 2.6 bn in 2020). The recovery in domestic demand was largely offset by the uptick in exports. Aluminum, which is SA's main export (12% of total), particularly benefitted from a boom in prices, gaining +8% over the year. This dynamic has compensated for the sharp drop in financing inflows.

The current account deficit should remain limited in 2022 and 2023 thanks to favourable terms of trade. However, the conflict in Ukraine will drive up SA's import bill on the back of rising oil and gas prices (accounting for over 20% of total imports). The increase in key export prices will only partially offset the fall in demand volumes. Global demand is expected to drop, notably from China (10% of total imports), which is currently facing its worst Covid outbreak. The increase in key export prices will only partially offset the fall in demand. Trade disruptions could also be the opportunity for SA to accommodate the unmet demand caused by the sanctions on Russia, which is an important producer of palladium and platinum. All in all, we expect the trade balance to drop from USD 32 bn in 2021 to USD 17 bn in 2022.

The current account deficit will represent only -0.1% of GDP while external debt repayments are expected to reach more than 6% of GDP in 2022. However, the country should benefit from larger FDI and portfolio net inflows from 2022. Financial and capital accounts are expected to cover the equivalent of 2.6% of GDP.

EQUITY PERFORMANCE AND SOVEREIGN BOND YIELD INDEX

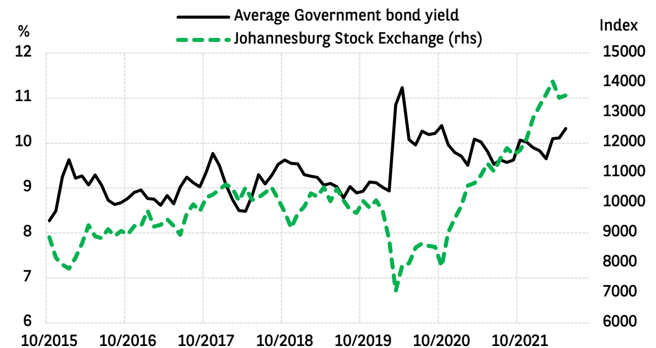


CHART 14 SOURCE: JOHANNESBURG STOCK EXCHANGE, RESERVE BANK, BNP PARIBAS

IMPROVING CURRENT ACCOUNT BALANCE

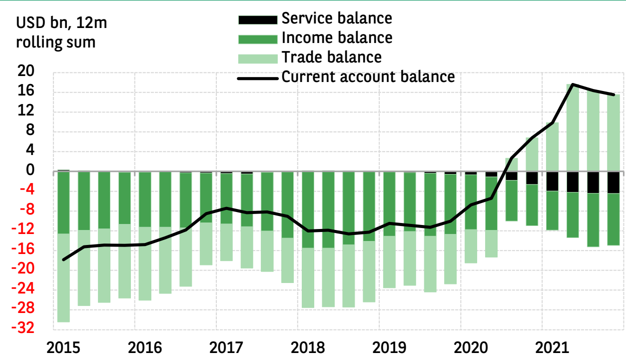


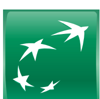
CHART 15 SOURCE: IMF, BNP PARIBAS

Structural vulnerabilities but mitigating factors

SA's reliance on volatile sources of financing and notably foreign portfolio investments in local currency (*Chart 16*) exposes SA to the tightening of global financing conditions in the medium term. Capital inflows have been facilitated by the accommodative global financing conditions, SA's attractive liquid domestic markets and the high yield of government bonds. Foreign debt ownership has become significant, exposing both the sovereign and the private sectors to external financial shocks. Nevertheless, the situation has started to change. First, the rise in sovereign risk has led to sales of local Treasury bonds by foreign investors. Second, global financial conditions are now becoming less favourable and might result in further net sell-off from foreign investors. External refinancing risks are expected to increase but are mitigated by some backstops.

First, the level of SA's external debt is moderate at below 40% of GDP at end-2021 (*Chart 1è*). Foreign-denominated external debt represents about 51% of the total and only 20% of GDP. External debt benefits even more from its favourable profile as the bulk of it (83% of total) is long term.

Second, the free-floating exchange rate regime acts as a shock absorber in the event of financial shock. External account deterioration leads primarily to currency depreciation (and financial market corrections) before a fall in FX reserves. Central bank intervention is rare but ad-



justments are made easier by the limited exposure of local institutions to currency risk.

In addition, the prudential limits on local institutional investors' exposure to foreign assets represent a cushion in case of financial shock. While capital controls for nonresidents have been completely cancelled, some remain for residents. The system is based on prudential limits on residents' capital outflows and the holdings of foreign assets by local institutional investors[3]. These limits have been increased gradually. Last February, the regulation was amended to allow domestic funds to invest up to 35% of their assets offshore (vs. 30% previously). From this, 10% of total assets should be dedicated to investment in Africa. During episodes of capital outflows, the depreciation of the ZAR automatically increases resident investors' holdings of foreign asset as a percentage of total assets under management. Accordingly, they have to repatriate some of their funds to comply with the prudential limit, thereby playing a stabilizing role during episodes of turmoil.

Finally, SA has a large domestic investor base and benefits from a deep and liquid market. Domestic investors thus are able to provide a buffer in case of capital outflows. The liquid market in fact offers rapid adjustments in investors' positions.

Banking sector

SA's financial sector is large, sophisticated, and complex with significant linkage across sectors. It is dominated by banks (with assets representing about 120% of GDP) followed by pension and investment funds (togetherrepresenting140% of GDP). The banking sector is well supervised and benefits from strong capital buffers that help it withstand shocks and mitigate systemic risk.

Nevertheless, banks' operating environment (marked by sluggish growth, low interest rates and financial volatility) has become increasingly challenging over the past few years. In the meantime, the nexus between the financial sector and the sovereign has tightened and is expected to remain a key risk for financial stability over the medium term.

A sound and well-capitalised banking sector

The banking sector is sound and well regulated by the SARB, which is considered to be an independent and credible authority. Risk management standards are high, banks are overall rather profitable and post higher-than-required capitalization and liquidity ratios. The banking sector is characterized by high concentration with the five largest banks holding more than 90% of banks' total assets.

The pandemic shock has had a negative impact on banks' balance sheets and overall profitability. In fact, the sharp interest rate cuts coupled with the lockdown dampened banking sector activity. Smaller banks have been affected the most but do not pose systemic risk given their small share of the banking sector's total assets. On the other hand, the performance of the main banking institutions has remained relatively positive. The sector's stringent risk management and commitment to prudential regulations actually provided banks with the tools to manage credit risks well and maintain their levels of capitalization (*Table 2*). CET1 capital adequacy only slightly decreased during the crisis and has recovered its historical highs in the past few months. In February 2022, it stood at 15.2% while the total capital adequacy ratio reached 18.1%, which is above the pre-pandemic levels and the required minimum.

3 For further details, see Regulation 28 of the Pension Funds Act.

RELIANCE ON PORTFOLIO INVESTMENTS FOR EXTERNAL FINANCING

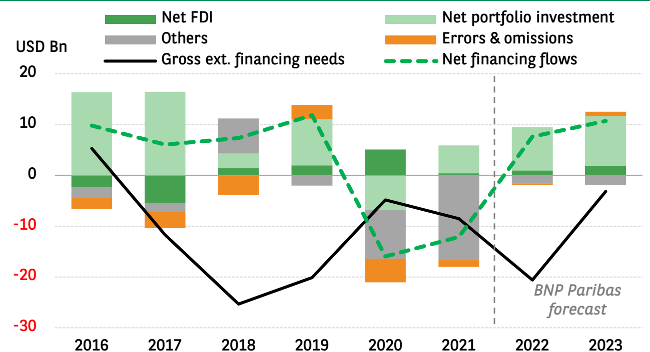


CHART 16 SOURCE: SOUTH AFRICAN RESERVE BANK, BNP PARIBAS

WEAKENING OF FOREIGN CAPITAL INFLOWS

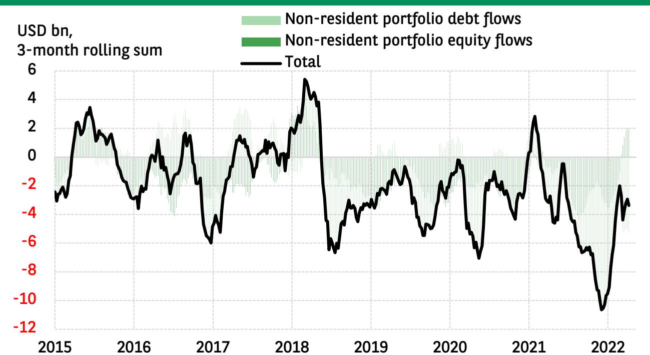


CHART 17 SOURCE: IIF, BNP PARIBAS

LIMITED EXTERNAL DEBT

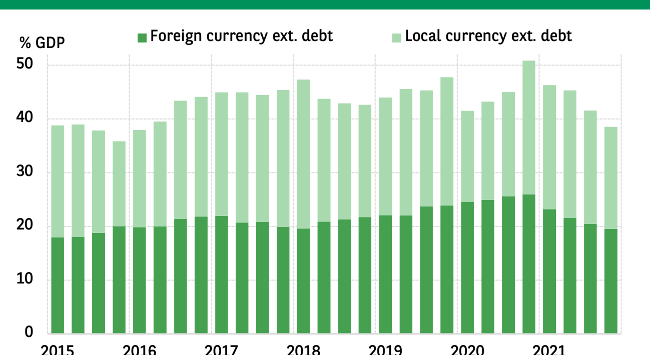


CHART 18 SOURCE: SOUTH AFRICAN RESERVE BANK, BNP PARIBAS

This illustrates the resiliency of the banking sector despite credit losses and declines in profitability. We believe the banking sector capital buffers are adequate to face any unexpected pressure on asset quality in 2022.

The sector however appears to be under some pressure. Asset quality has deteriorated, and NPLs are reaching a record high, currently accounting for more than 5% of total gross loans. Households and companies have not yet fully recovered from the Covid crisis, and their subdued earnings have weakened their ability to repay their debts. Temporary support measures (to promote restructuring and provide capital and liquidity relief) are currently being phased out. At the same time, improved economic activity should allow the normalization of credit risk in the coming months.

Profitability ratios just started to improve but remain below their pre-pandemic levels at respectively 13.8% and 1.1% (vs. 15.3% and 1.2% on average in 2019). In the coming year, we anticipate the overall banking sector's profitability to recover somewhat as the gradual normalization of monetary policy should help to improve margins while banks may lower provisioning costs. However, in the medium term, profitability ratios should remain under some pressure. In fact, the sector is structurally hampered by weak gains in productivity and the lack of dynamic economic growth. Cost-to-income ratios have climbed over the past few years and now stand at 58.2%. Investment in technology and digital banking currently puts pressure on operating costs, but it is expected to allow reduction of costs in the medium term.

Exposure to significant credit risk

Over the past few years, total domestic bank credit has grown slowly and amounted to 73% of GDP in 2021 (up from 70% of GDP in 2010), of which 42% was granted to households, 50% to companies and 9% to the government. During the crisis, the significant rise in the domestic credit ratio to GDP was primarily driven by the contraction in GDP: credit grew by only 3.8% in nominal terms in 2020.

In 2021, credit growth also remained subdued and was especially held back by corporate credit (+0.6%) while the momentum of growth in household credit was stronger (+5.1%).

Credit risk has risen and is expected to remain significant in the current economic context. While NPL ratios have reached record highs with the crisis, the rising leverage of households, risk concentrations and high share of corporate loans denominated in foreign currency continue to raise concerns. With the crisis, household debt as a percentage of income reached more than 75% and is estimated to have been 70% in Q3 2021 with debt servicing accounting for nearly 8% of disposable income (*Chart 20*). In the meantime, their ability to repay remains complicated by high inflation and the unprecedentedly high unemployment rate. In the corporate sector, credit leverage is more limited but marked by higher exposure to currency risk given the fact that 41% of the total is denominated in foreign currency. Overall loan quality will depend on the recovery of corporate profitability and households' levels of wealth.

While currently high commodity prices might boost corporate earnings, inflation pressure may have a rather negative impact on businesses and household incomes while interest rates are trending upward.

Meanwhile, major risks stem from banks' rising exposure to the sovereign. In fact, the overall banking sector's soundness is increasingly constrained by its rising exposure to sovereign risk and accounted for about 17% of total banking assets in 2021 (vs. 6% in 2008) (*Chart 21*). With sovereign risk continuously deteriorating, it poses a risk for banks' capacity to adequately increase their capital buffers (they currently have little capital to provision for it). Exposure to sovereign risk and potential valuations losses are likely to put greater pressure on banks' future profitability, capital positions and funding. Meanwhile, banks' exposure to SOEs is relatively limited. Nevertheless, in an environment

BANKING SECTOR MAIN MACROPRUDENTIAL RATIOS

	2019	2020	2021*
Capitalization (%)			
CET 1	13.6	13.6	15.2
Capital to total assets	16.6	16.6	18.0
Net open FX position to capital	0.9	0.1	0.8
Foreign-currency loans to total loans	8.6	9.0	8.3
Profitability (%)			
ROA	1.15	0.52	1.1
ROE	14.37	6.96	13.8
Cost to income ratio	58.8	58.7	58.2
Liquidity (%)			
Liquid assets to total assets	15.0	15.2	15.8
Liquidity coverage ratio	143.3	138.8	144.8
Assets' quality (%)			
NPL	3.9	5.2	5.0
NPL minus provisions to capital	25.1	25.1	23.0

* May or December

TABLE 2 SOURCE: SARB

HOUSEHOLD DEBT BURDEN

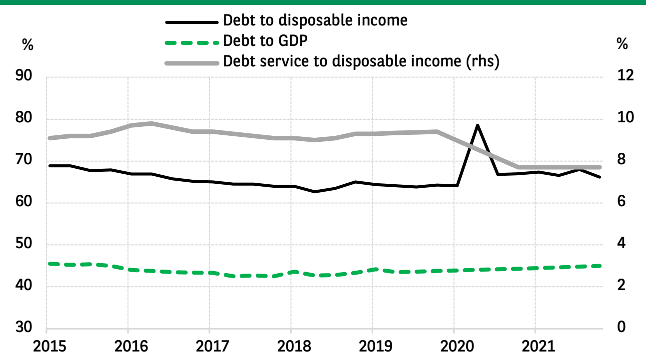


CHART 19 SOURCE: SOUTH AFRICAN RESERVE BANK, IMF, BNP PARIBAS

where SOEs' access to capital markets is likely to decline, banks may have to increase their absorption of SOEs' credit. Moreover, doing so may eventually crowd out private-sector lending.

Vulnerability to climate change

Significant exposure to climate change

Its weather conditions, geographical location and especially its dependence on energy expose South Africa to climate risk. In fact, the country is exposed to both physical and transition risks as is illustrated by its ranking in the ND Gain index in 2020 (91 out of 181 countries).

Climatic hazards (droughts, floods, fires, etc.) in South Africa have had significant impacts in recent years. Climate change manifests itself particularly through changes in temperature with the increase in the frequency and severity of periods of high heat, and frequency of precipitation. Analysts estimate that since 1990, the average temperature in SA increased twice as much as global temperatures[4]. In recent years,

4 Climate impacts in southern Africa during the 21st Century, Report for the Centre for

periods of drought have also been prolonged. Between 2015 and 2017, the region had the least rainfall ever recorded, which led to a gradual depletion of the water supply reservoirs and the risk of shortages. The 2017 Knysna fire is also attributed to prolonged periods of dry conditions and high temperatures. Besides the damage to the ecosystem, the increase in temperatures also has an impact on the labour force by reducing the availability of workers in the industries that are highly exposed to heat (for example, agriculture and mining), with an impact on productivity. In a country with low labour mobility, the impact of climate change is likely to put increasing pressure on the already struggling labour market. In addition, the challenges related to the increasing rate of urbanisation and the scarcity of critical infrastructure services are compounded by climatic stressors, which put additional pressure on service delivery and finances.

More frequent and severe climate hazards, most particularly floods and droughts, also have had increasing impact on the country. The current flood in the port of Durban for instance (through which 60% of South African trade exchanges transit), resulting from the heaviest rainfall in more than 6 decades has led to the suspension of shipping and significant infrastructure damage. A ZAR 1 bn in budget relief was decided to cope with the latter and additional resources might be approved, putting further pressures on the already strained budget.

Difficult efforts towards transition

According to experts, the impact of climate change could cause a loss of up to 23% of GDP in South Africa by 2050. Given the projections and increasing impact of climate hazards, the South African government drafted its National Climate Change Adaptation Strategy (NCCAS) in 2019. This strategy presents a vision for adapting to climate change and building the resilience of the country. It committed to achieving carbon neutrality by 2050 and plans to invest up to USD 2 bn per year (0.67% of GDP) in climate transition.

Nevertheless, the structure of the economy and absence of fiscal room for manoeuvre represent major obstacles for the achievement of this objective. The economy is in fact largely dependent on coal, which accounts for 80% of the energy mix and a considerable share of jobs. South Africa is one of the most energy intensive economies. Its energy footprint is considerable: emissions are around 7.6t per year and per inhabitant, making it the 14th emitter worldwide. In addition, the allocated capital remains below the objectives for the moment. Some actions are being taken to rely on renewable energy resources more intensively and suffer less from Eskom's energy load shedding. The country is in fact endowed with large biomass, wind and solar energy potential. In 2021 for instance, the government notably granted 25 contracts to the private sector for renewable energy projects (wind farms and photovoltaic plants) aiming to increase the electricity generation capacity by 4.5%. That being said, the stimulus policies implemented in the context of recovery have extensively participated in revitalising the coal sector.

INCREASING SHARE OF SOVEREIGN IN TOTAL ASSETS

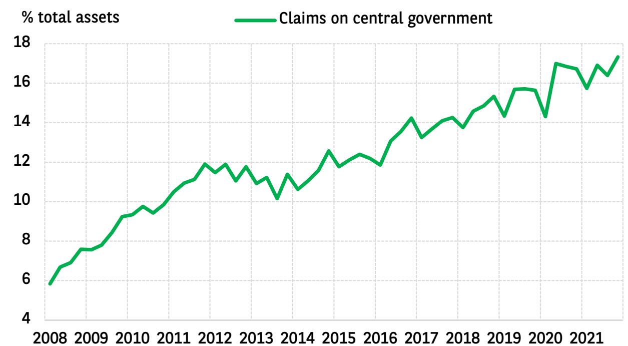


CHART 20 SOURCE: IMF, BNP PARIBAS

HISTORICAL AVERAGE TEMPERATURES AND PRECIPITATIONS

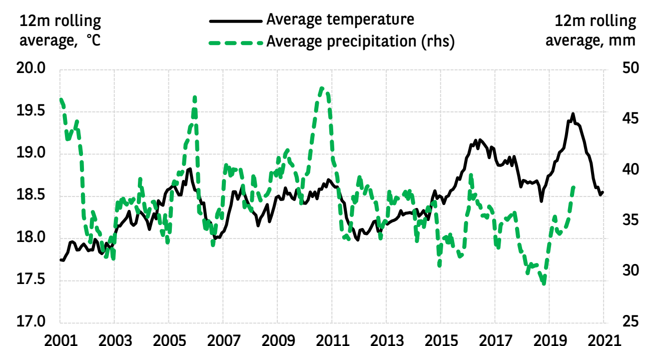


CHART 21 SOURCE: WORLD BANK, BNP PARIBAS

Conclusion

Although a few macroeconomic indicators recovered in the wake of the crisis, South Africa's outlook is fragile. The evolution of sovereign risk remains particularly at the center of attention and will be closely monitored over the coming months. Weak growth combined with rising inflation could indeed make fiscal adjustment difficult and further delay the investments needed to increase growth potential and overcome structural constraints. Moreover, a potential fiscal slippage could have significant repercussions on both the banking sector and the confidence of investors, whose risk aversion remains high in the current global economic context.

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Environmental Rights, R.Scholes & F.Engelbrecht Global Change Institute, September 2021

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