SOUTH AFRICA

A WEAK FISCAL SITUATION

At year-end 2021, the South African economy had not returned to pre-Covid levels of activity. The upturn in the price of its main export products provides the country with a welcome boost in the short term. This is illustrated by the latest budget forecasts, which are more optimistic than those published in late 2021. Yet structural vulnerabilities persist and are exacerbated by the health crisis. Although South Africa has few direct trade ties with Ukraine and Russia, it faces, like other emerging economies, soaring inflation that will strain domestic demand. The swelling public-sector wage bill and financial support for state-owned companies continue to be strong headwinds for reducing the fiscal deficit. Even if the government manages to balance the primary deficit by 2023-2024, its debt ratio will continue to rise. This risks creating a crowding-out effect that hampers growth while the economy was already facing stagnation risk before the two recessionary shocks.

At the end of 2021, unlike most emerging countries, the South African economy had not returned to its pre-Covid level of activity. The country faces the new shock of the Ukraine war in this context of incomplete and fragile recovery. This increases uncertainty even though South Africa (SA) has limited direct economic ties with the two belligerent countries. SA will certainly benefit from a slight increase in its export revenues, but the overall economic impact will nevertheless be negative. Rising commodity prices, disruptions in value chains and higher uncertainty are likely to affect the country's economic outlook.

THE FRAGILITY OF THE FISCAL SITUATION EXACERBATED BY THE PANDEMIC

South Africa's public finances have deteriorated rapidly in recent years against a backdrop of anaemic growth, declining productivity and continuously rising public spending. All of these factors have driven up the fiscal deficit, which swelled from -4.1% of GDP in FY2014/15 to -6.1% in FY2019/20. Hopes for a fiscal turnaround with the arrival of the Ramaphosa government in 2018 were quickly dashed. The situation has deteriorated constantly, with notably a steady increase in debt servicing (+12.5% a year) and the public sector wage bill (+6.5% a year between FY 2014/15 and FY 2019/20).

Fiscal slippage has accelerated over the past three years. In 2019, the rescue plan for Eskom, the state-owned power company, for nearly ZAR 60 bn (1% of GDP) further widened the deficit. In 2020, faced with an unprecedented economic recession, the authorities extended the expansionist economic policy with a vast stimulus plan. Estimated at ZAR 500 bn (USD 27 bn, 10% of GDP), the emergency measures considerably increased public spending (at an average annual rate of +9% between FY2018/19 and FY2019/20, compared to the previous fiscal year). Over the same period, revenues declined at an average rate of -4%, feeding concerns about fiscal deficit and debt dynamics.

The deficit swelled to -9.9% of GDP in FY2020/21 and public debt reached nearly 71% of GDP. The deficit was easily financed at a reasonable cost thanks to increased support from official creditors via low-interest credit lines and greater use of government bond issuance on the domestic market. In 2021, in the context of recovery, the deficit was slightly reduced but the public debt ratio continued to rise.

OPTIMISTIC BUDGET FORECASTS NEED TO BE TONED DOWN

For the coming fiscal year, the government released at the end of February more favourable budget forecasts than those published in late 2021. Yet this optimism was mainly fuelled by cyclical factors, while structural vulnerabilities persist.

FORECASTS

	2019	2020	2021e	2022e	2023e
Real GDP growth, %	0.1	-6.4	4.6	1.3	1.2
Inflation, CPI, year average, %	4.1	3.3	4.5	6.5	4.5
Central Gov. balance / GDP, % (1)	-6.1	-9.9	-5.2	-4.2	-4.0
Central Gov. debt / GDP, % (1)	57.4	70.7	72.4	78.4	81.3
Current account balance / GDP, %	-2.6	1.8	3.8	1.3	0.8
External debt / GDP, %	42.6	47.8	55.8	45.8	40.8
Forex reserves, USD bn	55.1	55.5	57.6	58.0	57.3
Forex reserves, in months of imports	8.4	6.6	5.9	5.6	5.2

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

SIGNIFICANT BUDGET DEFICIT

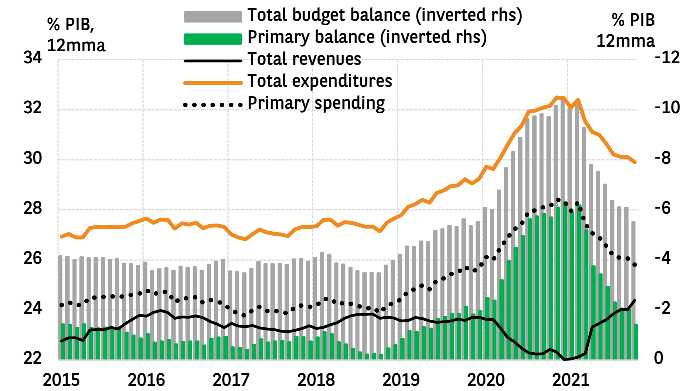

CHART 1

SOURCE: STATISTICS SOUTH AFRICA, BNP PARIBAS

The deficit for FY2021/2022 was revised downwards thanks to the stronger-than-expected growth in fiscal revenue, driven by the upturn in the prices of mining products.

For the fiscal year 2022/23, high prices for South Africa's main export products (aluminium, gold and diamonds) should result in an even bigger fiscal windfall. In contrast, the government is surprisingly unlikely to raise fuel taxes since it does not want to aggravate the increase in crude oil prices on pump prices.

On the spending side, the government maintained its proposal to control current expenditures, with a 4% increase compared to the previous year. This is in line with the increase in social welfare programmes and the extension of the one-time welfare allowance, set up during the pandemic. For the moment, the ZAR 350 subsidy has been extended through March 2023, for a total cost estimated at ZAR 44 bn (0.7% of GDP). The strategy for consolidating spending depends primarily on controlling public sector wages (which account for nearly 35% of total current expenditures) and the absence of additional transfers to support state-owned companies. The cost of debt servicing remains the fastest-growing expense (+12% a year on average in FY 2022/23 and FY 2023/24), far outpacing the expected nominal growth rate. Consequently, the budget is based on optimistic projections of GDP growth in real terms of 1.9% in FY 2022/23 and 1.7% in FY 2023/24. Yet since the budget was elaborated before the outbreak of the war in Ukraine, we esteem that actual growth will be slower (+1.5% and +1%, respectively, in FY 2022/23 and FY 2023/24 according to our estimates) mainly due to the decline in domestic demand.

The war in Ukraine is triggering higher inflation, which is likely to erode domestic demand. South Africa has few direct trade ties with Ukraine and Russia (0.8% of total imports in 2020), but its status as a net importer of hydrocarbons and grains exposes the country to a general increase in prices and supply chain disruptions. Already present through the impact of the global recovery via higher energy prices, inflation pressures are beginning to spread to other items such as food. Consequently, we have drastically revised our inflation forecasts: we are now looking for inflation of 6.5% in calendar year 2022 and 4.5% in 2023.

In spite of the rise in inflation, the debt ratio should increase and reaches more than 72% of GDP according to our forecasts. Such a high debt burden will make it hard to stabilise, despite a moderate fiscal deficit excluding interest charges, and forecasts calling for a return to a balanced budget as of FY 2023/2024. The significant gap between real interest rates and GDP growth is fuelling a snowball effect (see chart 2) in which debt servicing accounts for nearly 15% of total spending (more than 4% of GDP). Moreover, the cost of borrowing could rise for the government at a time of monetary tightening.

For the moment, the structure of the debt (average maturity of 12 years, only 10% of which is denominated in foreign currency, while the share of debt in the local currency held by non-residents has been reduced from 37% to 28% since 2019) will soften the impact of rate increases and currency depreciation, and limit refinancing risks. Nonetheless, the international environment is bound to increase risk aversion and force the government to refinance in the short term, which would only accelerate the snowball effect.

KEY CHALLENGES

In addition to the various repercussions of the war in Ukraine, three sources of pressures could thwart the fiscal consolidation plans.

First, the local population is increasingly dissatisfied with higher prices in an already tense social climate. Given the pressures created by income inequality and historically high unemployment (more than 35% at year-end 2021), the subsidy may have to become permanent and other subsidies may have to be implemented as well. For the moment, the government has only decided to reduce the fuel tax (−40%), which should have a neutral impact on the budget thanks to the sale of strategic oil reserves.

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

PERILLOUS DEBT TRAJECTORY

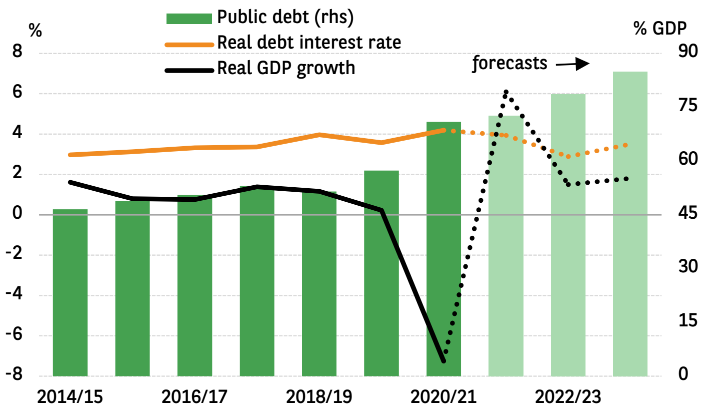

CHART 2 SOURCE: NATIONAL TREASURY, BNP PARIBAS

Unions are asking the government for an annual nominal wage increase of nearly 8% (which corresponds to the inflation rate plus 2 percentage points) compared to a wage increase of just over 2.6% provided in the FY 2022/23 budget. Although the government has some flexibility to offer a slightly higher nominal wage increase than budgeted, the raise demanded by the unions would require additional measures to contain spending and/or reduce staff. From this perspective, the current talks will be decisive.

Lastly, the difficult financial situation and poor performance of state-owned companies could require the government to make new capital injections. The liabilities of state-owned companies are a major fiscal burden with state-backed guarantees accounting for more than 9% of GDP. For example, the potential assumption of Eskom's debt would account for ZAR 329 bn (USD 25.8 bn). Debt restructuring decisions have been constantly delayed, and the 9.6% electricity tariff increase in FY2022/23, which was well below the 20.5% requested, will continue to add to the financial hardships of the company.

Just recovering from the pandemic crisis, South Africa's fiscal prospects remain extremely fragile. In the short term, temporary revenue growth could be offset by the impact of weaker-than-expected growth and fiscal adjustments that will widen the deficit. In the medium term, the crowding-out effect of fiscal imbalances on investment spending are likely to persist and continue to strain growth. From this perspective, South Africa's economic prospects appear tilted to the downside.

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