SOUTH AFRICA

A WELCOME EXPORT REVENUE WINDFALL

South Africa has been severely hit by the Covid-19 crisis, after already several years of very low economic growth and social and political tensions. Real GDP collapsed by 7% in 2020 and public finances have deteriorated significantly. However, South Africa has also benefitted from a strong improvement in its external accounts. The boom in export receipts has supported the rebound in activity and fiscal revenue over the past year. This better-than-expected macroeconomic performance has reassured investors and facilitated the coverage of the government's financing needs. However, in the medium term, challenges remain unchanged: large and difficult reforms remain necessary to elevate the country's growth potential and improve public debt sustainability.

The Covid-19 crisis has plunged South Africa into a severe economic and fiscal crisis, following several years of weak GDP growth and gradual deterioration in public accounts. Real GDP contracted sharply in 2020 and sovereign solvency worsened significantly due to the rapid increase in fiscal imbalances and public debt. Nonetheless, over the past year, macroeconomic performance has been better than initially feared, notably because South Africa has benefitted from a great improvement in its terms of trade. Strong export receipts have helped the rebound in fiscal revenue since Q3 2020. Current account surpluses have fueled ZAR appreciation, strengthened external liquidity, and contributed to lower financing stress for the government. In the meantime, President Ramaphosa appears to have strengthened his authority within the ruling ANC over the past year, which has contributed to an improved market sentiment as this enhances the prospects for structural reform.

Favourable external-account dynamics are reducing the sovereign's refinancing risk and currency pressure in the short term but, in the medium term, challenges remain unchanged: South Africa absolutely needs to strengthen its economic growth potential, which will in turn help reduce socio-political risks and improve its public-debt dynamics.

FORECASTS

	2019	2020	2021e	2022e
Real GDP growth (%)	0.2	-7.0	4.7	2.1
Inflation (CPI, year average, %)	4.1	3.3	4.5	4.2
Government balance / GDP (%) 1	-6.7	-11.0	-9.2	-8.0
Government debt / GDP (%) 1	63.4	78.8	80.9	84.5
Current account balance / GDP (%)	-3.0	2.2	1.6	-1.7
External debt / GDP (%)	52.8	56.4	46.0	43.9
Forex reserves (USD bn)	48.9	47.4	52.0	48.3
Forex reserves, in months of imports	5.7	7.3	7.1	5.7

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

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

EXPORT REVENUE WINDFALL

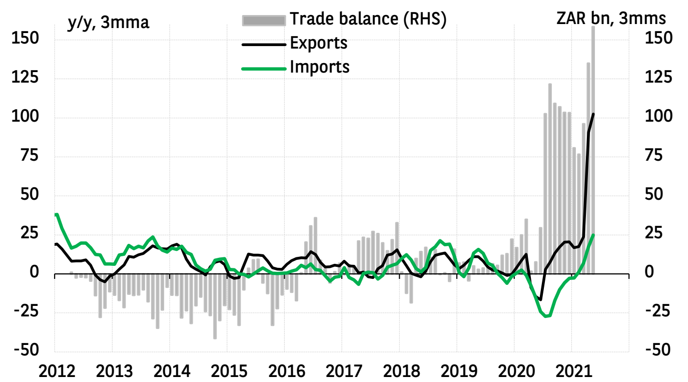

CHART 1

SOURCE: SARS

NET EXPORTS HAVE DRIVEN THE POST-COVID-19 REBOUND

Real GDP contracted by 7% in 2020, after it grew by a very low 0.8% per year on average in 2015-2019. Real GDP collapsed in Q2 2020 (-16.6% q/q) due to the lockdown, and has rebounded since mid-2020 (+13.7% q/q in Q3; +1.4% q/q in Q4 and +1.1% in Q1 2021), mostly supported by monetary and fiscal stimulus policy measures, surging export revenue and rebounding production in the mining sector. Meanwhile, construction activity and many services sectors relying on domestic demand have remained depressed.

After falling in April-May 2020, export receipts have rebounded vigorously, boosted by recovering volumes and, most importantly, soaring prices of exported commodities. Precious metals and mining products accounted for 46% of South Africa's total exports in 2020. Trade surpluses have exceeded USD 3.5 bn per month since March 2021 (vs. an average of USD 150 m per month in 2019), and the quarterly current account balance has been in surplus since Q3 2020. In the very short term, export growth performance should remain buoyant.

DOMESTIC DEMAND RECOVERY IS MORE DIFFICULT

Helped by monetary and fiscal support measures, household consumption has rebounded faster than domestic investment following the Covid-19 shock last year. In 2020 as a whole, it contracted by 5.4% in real terms. However, it may struggle to continue to recover going forward. Firstly, South Africa has been facing a third and particularly severe wave of infections since May. The number of cases has increased very rapidly in recent days, leading President Ramaphosa to announce new restrictions, with the country being moved to an adjusted level-4 lockdown for at least two weeks from June 28. This is likely to derail the economic growth momentum and makes forecasts uncertain pending faster progress in the vaccination campaign – at the end of June, only 5% of the population had received one dose of vaccine, vs. 1.6% at the end of May.

Secondly, private consumption should remain constrained by last year's sharp deterioration in the labour market; at end-Q1 2021, total employment was still 9% below its end-Q4 2019 level and the unemployment rate was 32.6%.

Meanwhile, many enterprises have reduced drastically their capital expenditure. After already several years of gradual decline, domestic investment collapsed by 17% in real terms in 2020, falling to a record low of 12.4% of nominal GDP. Corporates remain vulnerable and cautious, and wait for much further progress in structural reform. More generally, structural brakes on economic growth (such as deficient transport and energy infrastructure, corruption and weak human capital) will continue to hinder activity; in particular, episodes of electricity cuts are expected until at least late 2022 before energy supply is durably strengthened.

On the positive front, the monetary authorities are projected to maintain an accommodative policy stance in the very short term, even though inflation is starting to accelerate. Consumer price inflation rose from 3.1% y/y in December 2020 to 5.2% in May 2021, which is still within the central bank's targeted band of 3%-6%. Since July 2020, the policy (repo) rate has been maintained at a record low 3.5% and the real prime lending rate has remained close to 3.7%. This has supported a small recovery in loans to households in recent months but loans to corporates have continued to be weak. As a result, growth in total credit to the private sector has turned negative since March 2021 (reaching an average -1.3% y/y in March-May).

The low interest-rate environment and the extension of credit relief and regulatory forbearance measures will anyway continue to help corporates and households. When relief measures are unwound, sometime in the year ahead, banks' asset quality is expected to deteriorate (the non-performing loan ratio already increased to 5.2% at end-2020 from 3.9% at end-2019). The most vulnerable borrowers include households (which have a heavy debt burden, at 75% of disposable income at end-2020) and small enterprises.

On the fiscal front, although some support measures have been extended this year, the policy stance will be less supportive to activity in 2021 than last year due to the government's commitment to reducing its deficits.

PUBLIC FINANCE: SHORT-TERM RELIEF, MEDIUM-TERM WORRIES

Public finances weakened significantly due to the Covid-19 shock, following already several years of deterioration. Fiscal slippage worsened in 2019 as the government rescued the state-owned energy company Eskom, and then accelerated drastically in 2020 due to the economic recession and the large stimulus package (representing about 10% of GDP). The central government deficit rose to a (lower-than-expected) 11% of GDP in FY20/21 vs. 6.7% in FY19/20, due to soaring levels of primary deficit (6.4% of GDP) and interest payments (4.6%). National government debt rose to 79% of GDP in FY20/21 from 63% in FY19/20. In its budget plan that was published in February 2021, the government showed strong commitment to fiscal consolidation efforts and projected to reduce its deficit gradually from this year thanks to improved revenue and spending discipline.

In the short term, the sovereign's refinancing risk is low even if local bond yields are high (averaging 9.8% for government papers of over 10 years in H1 2021 vs. 9% in H2 2019). First, the government has been able to build some buffers in recent months thanks to its smaller-than-expected financing needs and continued issuance of domestic bonds amid an improved market sentiment. Second, there is abundant

EASING OF FINANCIAL TENSIONS

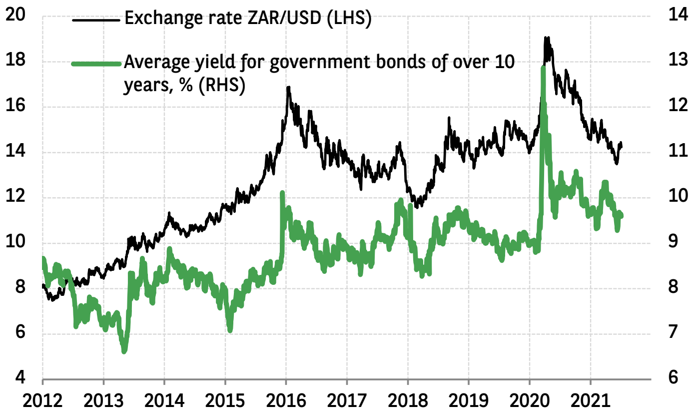

CHART 2

SOURCE: SARB

liquidity in the domestic financial system, and local banks still keep some room to buy more Treasury bonds and offset the impact of lower bond holdings by foreign investors (credit to the public sector and sovereign bond holdings rose to 17% of bank assets at end-2020 from 15% in Q1 2020). The share of foreigners stabilized at around 30% of total local-currency Treasury bonds since Q4 2020 (down from 37% at end-2019). The government is unlikely to need to resort to new multilateral loans like in 2020.

In the medium term, public debt dynamics are a major concern. Government debt will continue to grow (we project it to reach 87% of GDP at end-FY23/24), driven by wide (even though declining) fiscal imbalances and low GDP growth. This will keep the government particularly exposed to shifts in foreign investor sentiment and maintain pressures on local bond yields. Refinancing risk will trend upwards as a result. In order to improve public debt, fiscal consolidation and GDP growth prospects, the authorities will have to contain drastically growth in the public-sector wage bill, continue to restructure SOEs, and make progress in structural reforms. The political context has recently improved and become more conducive to such changes, and further steps in the right direction have been made (such as SOE management changes, continued transformation of Eskom, reform measures in the energy sector). However, socio-economic conditions have weakened significantly due to the Covid-19 crisis, and this will continue to make social welfare and public spending reductions particularly difficult. Moreover, the political landscape might deteriorate again, including in H2 2021 because of the municipal elections.

Completed on 5 July 2021

Christine PELTIER
christine.peltier@bnpparibas.com