South Africa

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The coronavirus crisis is hitting an economy that was already slowing in. It requires fiscal support from a government that already had very limited room for manoeuvre. While the near-term liquidity situation should be manageable, longer-term debt sustainability has become challenging.

Country Risk Analysis

Summary

The South African economy has been growing at an average pace of 1% in the past five years on the back of low investment and poor productivity growth. This is lower than most rating peers. A recession in the second half of 2019 is now expected to be followed by a GDP contraction of 4-6% in 2020.

The fiscal position has been consistently weak ever since counter cyclical measures were introduced during the global financial crisis in 2009. Since then, general government budget deficits have hovered around 4-5% of GDP and rising even higher last year. This year, the deficit could hit double digit levels.

The combination of low growth and high fiscal deficits has led to a rapid rise in debt/GDP over the past few years, creating increasingly challenging debt metrics. Although we do not expect immediate, near-term problems in refinancing debt redemptions, it is very unlikely that the debt/GDP ratio will level-out in the foreseeable future. This will lead to rising interest rate costs which risks crowding out investments needed to raise growth thereby risking to create a vicious negative spiral.

The only major credit rating agency to have had South Africa in investment grade recently downgraded the sovereign to sub-investment grade. Another agency downgraded the sovereign further into junk. Both are maintaining a negative outlook. It is unlikely that South Africa can get back to investment grade rating in the foreseeable future.

Recent economic developments

Growth remains relatively low. Economic growth has been about 1 % in the past five years on the back of low investment and poor productivity growth. This rate is lower than among rating peers and clearly lower than what is required to come to grips with the country’s social and labour market challenges. Consequently, the growth performance has been weighing on country risk for some time. Real GDP growth came to a virtual standstill in 2019 and GDP per capita is expected to have

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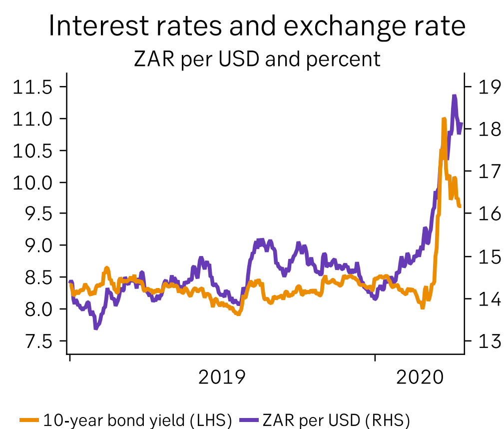
fallen for the fifth consecutive year. More recent data has been tepid, and expectations for 2020 were very low already before the onset of the corona crisis.

Moderate inflation, high unemployment. Sluggish economic activity has held back inflation which nonetheless rose to 4.6% recently. Meanwhile, about 29% of the labour force remains unemployed.

Investors have punished South African assets. The recent mayhem in global financial markets has not spared South Africa. Interest rate spreads have soared and the currency has lost about 28% versus the USD since the start of the year, temporarily reaching record lows. Net capital outflows have been significant, fuelled also by recent sovereign credit rating downgrades.



Persistent current account deficits. The current account deficit narrowed to 3% of GDP last year. This, per se, does not imply any significant imbalance. However, for several years, the deficit has been financed by debt and equity flows. Inward foreign direct investments (FDI) have been low and over shadowed by investments made out of the country. Reserves at the central bank rose over the past year. Although they barely cover outstanding short-term external debt, they are equivalent to more than 5 months of imports. This should be adequate given the country's flexible exchange rate.

External debt is moderate. External debt as a share of GDP has risen over the past years as non-residents have stepped up purchases of government securities denominated in rand. These flows started reversing in early 2020, however, and the IMF, before the current crisis, expected external debt to stabilise around the current 50-55% of GDP.

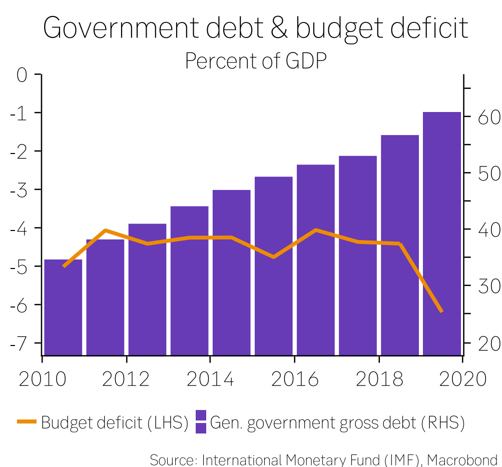
Economic policies

Responding to the current critical economic situation, the government has indicated it will seek new external financing from multilateral financial institutions, including the IMF (through its new temporary lending facility), to finance economic support programmes during the crisis.

Accelerating fiscal deterioration. The country's fiscal policy framework is considered robust and better than average for similar emerging markets. Nevertheless, since counter cyclical measures were introduced during the global financial crisis in 2009 general government budget deficits have been 4-5% of GDP. Key structural factors that have been driving the deficit over the past few years have been high public wage costs, high interest costs and support for SOEs**.** The IMF estimates that the consolidated budget deficit increased to 6.6% of GDP in the fiscal year that ended in March, a consequence mainly of rising transfers to SOEs and rising interest rate costs.

Rising government debt is an increasingly severe credit weakness. The combination of low growth and high fiscal deficits has led to increase in government

debt to GDP at a pace matched by few emerging markets. The general government debt is estimated to have risen to above 60% of GDP by the end of 2019 (IMF definition). This is higher than average among country risk peers. A continued rise is on the cards, creating increasingly challenging debt metrics. For example, interest rate costs as a share of revenues, already high compared to peers, are on the rise. A mitigating factor is that around 90% of the debt is denominated in local currency which limits the impact of the depreciating currency. This being said, in late 2019, nearly 40% of the local currency debt was held by non-residents. While this may help to improve liquidity in normal times, it also increases the vulnerability to shifts in global investor sentiment.



Contingent liabilities from state-owned enterprises are high and rising. Contingent liabilities to the government from the large state-owned enterprises (SOE) remain significant. The SOEs have struggled with financial problems for years as a result of operational inefficiencies and poor governance (despite some improvements over the past years). A high and rising share of the SOE debt is guaranteed by the government.

Power company Eskom in increasingly dire straits. By far the most important SOE is the large state power monopoly Eskom whose financial troubles has pushed it to the brink of collapse and caused extensive power outages. Eskom's debt represents almost 10% GDP, of which about 80% is guaranteed by the government. Troubles have increased over the past year forcing the government to commit to new capital injections. In addition, the government has replaced the board and management teams and a chief restructuring officer was appointed.

Banking sector relatively strong. The banking sector is relatively large with total assets equivalent to more than 100% of GDP. The IMF in a recent report characterised the sector as "strong and resilient", although naturally exposed to the slow economic growth. A key vulnerability remains banks' exposures to large state-owned enterprises. Responding to the ongoing sharp dip in the economy , the SARB has proposed a series of regulatory measures aiming at loosening liquidity and capital requirements for the banks.

Monetary policy has been loosened. Unlike most advanced countries with policy interest rates at zero, South Africa does have space to cut interest rates. The SARB recently, during a short time reduced the policy rate by 200 basis points to 4.25%, citing low inflation and very weak growth. In addition, the bank, which enjoys a high degree of credibility in financial markets, has launched various measures to inject liquidity in the markets. While there is room to lower rates further, the central bank will be mindful of its effect on the ZAR and the risk of triggering further capital outflows.

Major rating agencies now have the sovereign in sub-investment grade. Recently, two of the major rating agencies downgraded the sovereign, keeping a negative

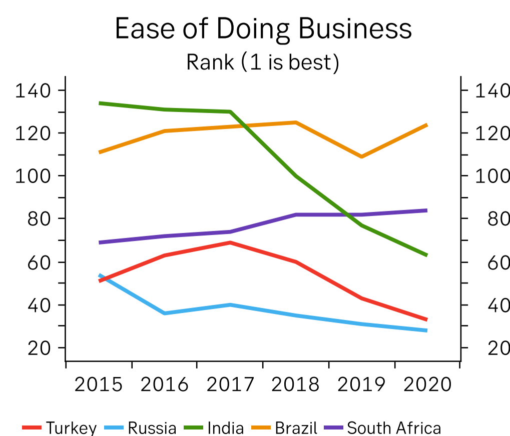
outlook. Arguments behind the downgrades were centred on lower growth prospects, deteriorating fiscal balances and an ever rising government debt. All of the rating agencies now have the sovereign in sub-investment grade and a negative outlook. The junk rating by all major agencies means the sovereign will be ejected from the FTSE World Government Bond Index in April which is likely to trigger selling by funds invested in the index.

Political situation

The ANC, led by Cyril Ramaphosa, won a clear majority in the May 2019 general elections despite getting its lowest share of votes ever. The increased importance of smaller parties in parliament has proved to be limiting the ANC's room to manouevre. The President is also facing opposition from factions within his own party, which have recently blocked key reforms, including relating to the labour market and SEOs. Some political factions have already begun positioning themselves for local government elections scheduled for 2021.

Structural issues

The country's resilience is held up by the relatively high quality of institutions such as the central bank and the legal system. Structural factors that weaken the resilience include deep social and political divisions, often rooted in high income inequality, that slows policy implementation. These weaknesses hold back economic growth. Growth is also held back by the limited flexibility in the labour market, skills shortages and, as mentioned, the poorly governed SOEs which leaves the country with an unreliable electricity supply. These factors weigh on business sentiment and is reflected in South Africa's low ranking in the World Bank's Doing Business index.



Outlook

Recession in near-term. Oxford Economics (OE) recently lowered their forecast for real GDP growth in 2020 to -4.9%. This would be a much worse than the contraction in 2019 following the global financial crisis. The slowdown is expected to be broad-based, hitting both external and domestic demand. The central bank forecasts a 6.1% contraction and expects the recovery in 2021 to be much weaker than OE's forecast.

Uncertain recovery. The pace of recovery is very uncertain, but our main scenario builds on a relatively rapid rebound in growth in 2021, followed by modest growth rates thereafter. Most projections of the longer-term prospects assume relatively limited progress on structural reforms needed to raise growth. Therefore, real GDP growth and growth in per capita incomes are likely to remain muted over the medium-term. Oxford Economics expect medium-term growth of about 2%. This would be low considering South Africa's level of development, and is not likely to have a material impact on the high level of unemployment.

Current account deficit may widen again. We expect some further widening of the current account deficit in 2020 which would increase the country's external financing needs. The central bank, on the other hand, expects some narrowing of the deficit due to import compression while the IMF even expects a small surplus.

Fiscal deficits will be difficult to reduce. Fiscal consolidation efforts will be derailed by the notable drop in economic activity, the related reduction in tax revenue and higher social spending. The government, before the corona outbreak, had planned to run a budget deficit of 6.8% of GDP in the FY starting in April 2020. Private sector forecasts now point to a double digit deficit. Even looking beyond the current crisis, it is difficult to see that the government will be able to come to grips with its high public wage costs, high interest rate bill and heavy support for SOEs.

Refinancing to be found domestically. As global investor sentiment towards emerging markets is expected to be muted in the near-term, the government will be forced to fund its fiscal deficit and bond redemptions more domestically the coming year. This should be feasible given the country's large and diversified domestic investor base. This being said, it will come at a higher cost than before. Furthermore, FitchRatings estimate that foreign currency debt redemptions will be about USD 1 bn per year over the coming two years. This should also be manageable.

Government debt to continue up, under most assumptions. Already before the corona virus crisis, the IMF had forecasted the public debt to rise to 77% of GDP by 2023. Moody's recently estimated that it will surpass 90% of GDP over the same period (including Eskom debt). Most analysts expect a continued rise over the next five years, irrespective of a range of varying likely assumptions.

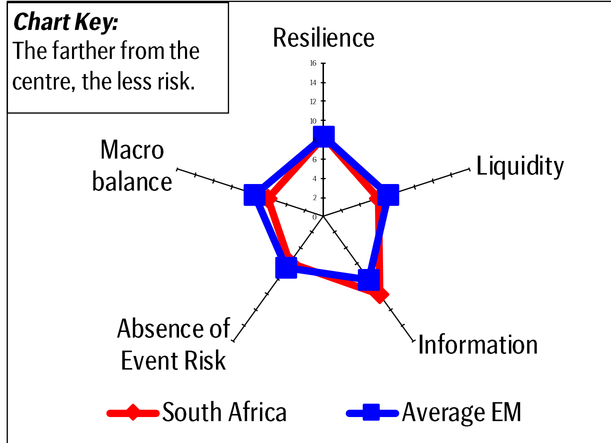
Risks to main scenario coming from worse than expected external developments. There is extreme uncertainty around the global economic outlook. Our main scenario assumes a global recession in 2020. However, risks to the downside clearly dominate. This includes global demand and global trade being lower for longer. In addition, South Africa's dependence on foreign funds makes the economy vulnerable to a further worsening of global investor sentiment.

Domestic political and social risk. Political risk remains important. The poor economic performance over the past decade has led to rising poverty, unemployment and income disparities. There is a risk that increasing public frustration could spark a surge in social unrest and political tensions, leading to a stand-still in economic policy making.

A full-fledged IMF programme is a risk on the upside. Some observers see the need for the authorities to turn to the IMF for a regular financing programme. They argue that committing to such a policy anchor would be the only way to get growth oriented reforms implemented and stabilise government debt. A full-fledged IMF programme would naturally be positive for country risk, but we assign a low probability that this will happen in the near-term as there is very little political support for it.

SOUTH AFRICA: RISK PROFILE

Key figures	2020
Population (millions)	54
GDP/capita (USD)	4794
Real GDP (% chg)	-4,9
Inflation (%)	2,2
Curr.Acc. Balance (% of GDP)	-4,6
Reserves/imports (months)	5
Budget balance (% of GDP)	-6,8
Government debt (% of GDP)	65



External ratings:
Fitch: BB / Sta
Moody's: Baa3 /Sta
S&P: BB/ Sta

Peers:
Brazil
Portugal
Russia

Graph: South Africa scores similarly to the average emerging market economy, except on the macro-balance indicator due to large current account and budget deficits.

South Africa: Key Economic Indicators

Macroeconomic	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**
GDP (USD, bn)	319	297	349	370	351	285	330	353
GDP/capita (USD)	5748	5282	6121	6384	5992	4794	5490	5797
GDP (change)	1,2%	0,4%	1,4%	0,8%	0,2%	-4,9%	4,8%	1,9%
Investments/GDP	21%	20%	20%	20%	20%	22%	21%	21%
Government finances								
Budget balance/GDP	-4,0%	-4,7%	-4,0%	-4,3%	-6,6%	-6,8%	-6,8%	-6,8%
Central gov't debt/GDP	47%	49%	52%	57%	61%	65%	70%	73%
Money and prices								
CPI inflation	4,6%	6,3%	5,3%	4,6%	4,1%	3,2%	4,0%	5,0%
Money demand (chg, yoy)	19%	15%	13%	13%	14%	15%	16%	17%
Stock prices avg.	55380	56089	56787	57473	58146	58802	59444	60071
Interest rates	6,2%	7,2%	7,2%	7,0%	7,0%	5,7%	5,3%	5,8%
Exchange rate (USD)	12,8	14,7	13,3	13,2	14,4	17,6	16,2	16,2
Trade/GDP	52%	51%	49%	51%	55%	73%	67%	66%
Oil price (Brent)	$52	$44	$54	$71	$64	$65	$64	$62
Balance of payments (USD, mn)								
Exports of goods	81 184	76 729	88 182	93 935	96 980	102 610	109 105	115 885
Imports of goods	84 747	74 264	82 733	93 221	96 987	104 179	111 405	118 194
Other:	-11 067	-10 851	-14 323	-14 025	-10 621	-11 439	-12 763	-13 269
Current account	-14 631	-8 386	-8 874	-13 312	-10 628	-13 008	-15 063	-15 578
(% of GDP)	-4,6	-2,8	-2,5	-3,5	-3,0	-4,6	-4,6	-4,4
FDI	-3 994	-2 275	-6 069	1 285	499	896	1 153	1 351
Loan repayments	-2 687	-7 420	-8 119	-11 031	-13 065	-15 184	-17 415	-19 533
Net other capital flows	19 460	15 932	24 646	26 746	27 149	31 013	35 548	38 578
Balance of payments	-1 851	-2 149	1 584	3 688	3 955	3 717	4 221	4 818
External debt and liquidity (USD, mn)								
Reserves (excl. gold)	39 063	39 064	40 647	42 752	44 601	46 469	48 823	51 287
in months of imports	6	6	6	6	5	5	4	4
Total debt	138 078	146 041	180 497	179 306	183 522	200 595	216 267	231 852
o/w short term debt	28 688	29 523	31 733	35 603	37 321	39 361	41 478	43 485

Source: OEF (Oxford Economic Forecasting), IMF and SEB estimates.

Rating history (EoY)				
Fitch	BBB-	BB+	BB+	BB+
Moody's	Baa2	Baa3	Baa3	Baa3

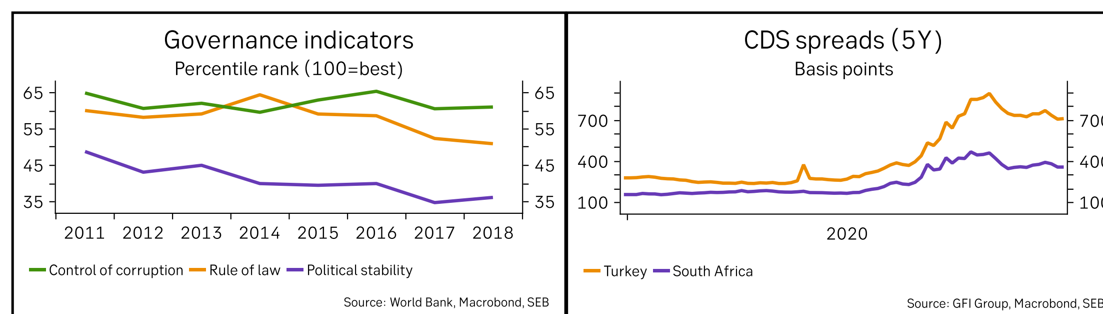
Type of government: ANC majority government

Next elections: Parliamentary and presidential elections 2024.

Other:

Latest PC deal: n.a.

Recent IMF programs: Compensatory and Contingency Financing Facility (CCFF) in December 1993.



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