South Africa: The economy looks vulnerable to a second wave of the virus

CHRIS J FINDLAY
ECONOMIC RESEARCH OFFICE | LONDON
T: +44-(0)20-7577-1712
E: christopher.findlay@uk.mufg.jp

MUFG Bank, Ltd.
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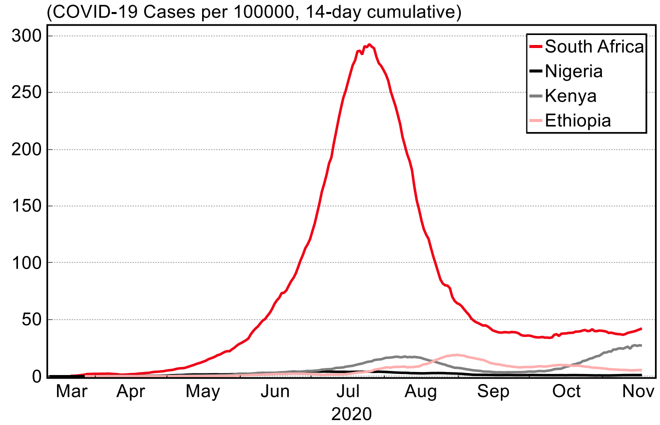
Economy Hit Hard by Initial COVID Shock

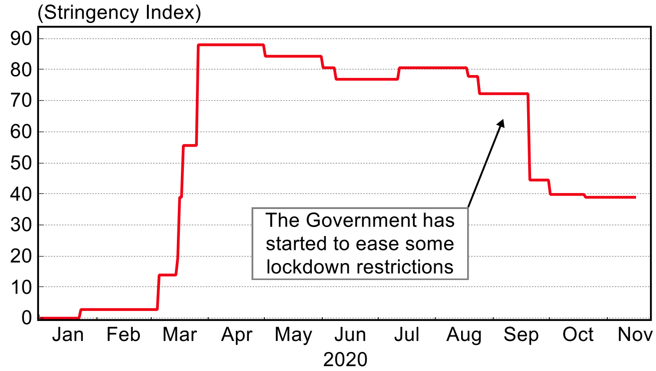
The South African economy, already in recession before the pandemic, has suffered from one of the largest outbreaks of the virus in the world with over 700,000 discovered cases. This led to the imposition of stringent lockdown restrictions in Q2 and GDP fell by a record 16.4% QoQ. In turn, the country's public finances, which were deteriorating even before the pandemic, have weakened significantly. The government had no option but to resort to emergency IMF funding with a ZAR 70 billion (USD 4.3 billion) loan approved in the summer. The package probably helped to support investor sentiment and, for now at least, there will be some respite for the economy. We expect that GDP will have rebounded strongly in 3Q following the easing of lockdown measures and the implementation of fiscal and monetary support measures. However, with the virus now spreading rapidly again in Europe, the US and elsewhere, risks to the outlook are clearly tilted to the downside – not least because policymakers have reduced fiscal firepower after costly support measures implemented during the initial wave.

Discovered COVID-19 Cases
(COVID-19 Cases per 100000, 14-day cumulative)



Source: ECDP&C, Macrobond, MUFG Bank Economic Research Office

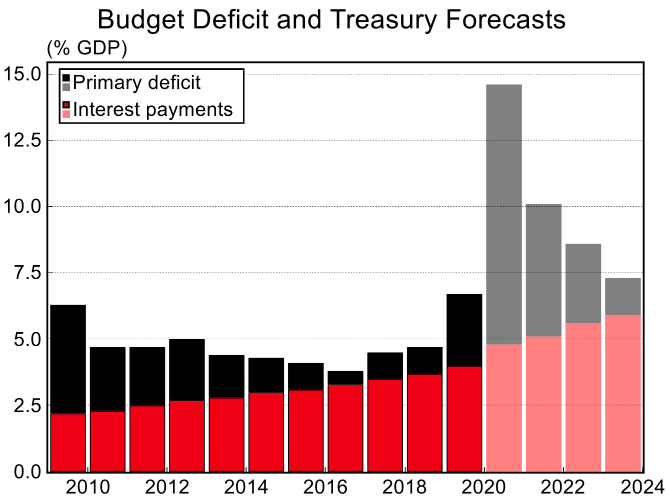
Oxford COVID-19 Government Response Tracker
(Stringency Index)



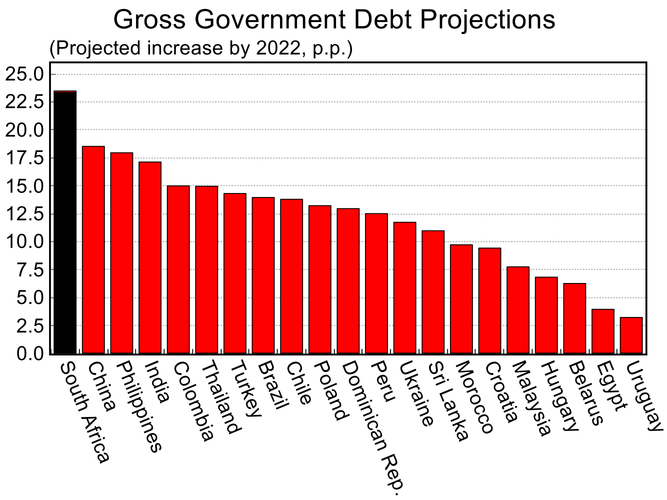
Source: Hale, Thomas, Sam Webster, Anna Petherick, Toby Phillips, and Beatriz Kira (2020). Oxford COVID-19 Government Response Tracker, Blavatnik School of Government. Data use policy: Creative Commons Attribution CC BY standard. Macrobond, MUFG Bank Economic Research Office

Fiscal Firepower is Now Reduced

After implementing a COVID-19 fiscal relief package equivalent to around 10% of GDP with funds used to protect jobs and businesses (via a loan guarantee system) and increase social welfare, the South African National Treasury now forecasts government debt to reach 82% of GDP next fiscal year (from 66% in 2019) with the deficit ballooning to 15% of GDP.



Source: SA MTBP, MUFG Bank Economic Research Office



Source: SA MTBP, IMF, MUFG Bank Economic Research Office

The budget deficit of roughly USD 48.2 billion will be funded mainly by domestic sources, with short-term borrowing accounting for a larger proportion of total funding in fiscal year 2020/21 (approximately 18.5%) given pressures on longer term funding which will account for another 59.7%. The remainder will come from extraordinary funding provided by IFIs (International Financial Institutions) such as the IMF, New Development Bank and AfDB, and potentially the World Bank further ahead. The IMF will loan a sum of USD 4.3 billion through its rapid financing instrument, with a further USD 3 billion due to come from the New Development Bank and AfDB.

However, while the use of extraordinary IFI funding will ease fiscal pressures in both the near and medium-term due to weaker conditionality [1] and lower interest rates compared to government debt raised commercially, the trajectory of future fiscal policy will clearly need to be altered. The government will remain under pressure to deal with long standing issues such as State Owned Entities (SOEs), and will be more reluctant to extend fiscal support measures. On top of this, there will also be far less room for fiscal support measures in the event of a second wave of coronavirus or if the economic recovery falters. Given limited policy options, calls for deeper economic reforms to re-invigorate the business environment and investor confidence have grown but plenty of political hurdles remain.

Challenges for Government's Reform Agenda

One of the main measures to help achieve fiscal consolidation according to the medium-term budget policy statement (MTBPS), will be to restrict the growth of the public sector wage bill by 1.8% this fiscal year, and by 0.8% over the rest of the MTBPS. Wage budget restrictions could reduce total spending by 6 percentage points nevertheless the government has also proposed a further wage freeze given the dire fiscal backdrop. However, the wage freeze will depend on the outcome of a court ruling on the government freezing of wages in 2020, set for December 2020, as well as negotiations with unions set for early-2021, with hurdles likely to be high.

[1] For example, IMF funding has a grace period of 3 years with no interest to be paid until 2023

Government debt service costs will also continue to rise over the medium term given high government debt, and on the revenue side, tax returns will remain under pressure as real GDP growth remains weak. Moreover, issues at the South African Revenue Service (SARS), and state-owned enterprises (SOEs), such as Eskom and South African Airways[2] will remain for a long while yet. In fact, the MTBPS has made some provisions for the bailout of South African Airways of around USD 675 million. The government is also looking to help Eskom, which has total debts of around USD 31.5 billion, yet with fiscal space so diminished, and the need to introduce a growth-friendly policy mix on top of this reform agenda, it is likely to be reluctant to roll-out fiscal measures that may have been more generous in the past.

One area that has been continuously identified over recent years is infrastructure spending. The government has presented a plan to boost infrastructure spending of around USD 22.1 billion (ZAR 340 million) over the next four years, and ensure sufficient electricity supply within two. However, given the fiscal backdrop, these plans will now have to rely far more on the private sector and international investors – at a time when investment appetite has weakened sharply. So far, around USD 21 billion has been pledged by banks, development finance institutions and multilateral organisations to the plan, with some of this figure already disbursed. However, despite this, some firms have already started to announce the cancelling or cutting down of capital projects.

Weak Economic Recovery Even Without a Second Wave

In terms of the more immediate economic outlook, a lot will hinge on the spread of the virus. For now, there are no signs of the second wave that is apparent elsewhere. In South Africa there have been around 40 cases per 100,000 people over the last two weeks, down from a peak of almost 300 in July. Indeed only certain limitations now remain on international travel, and there has been an increase in the number of people allowed at some social events. The country is currently in alert level 1, as of 21st September, which allows most normal activity to resume, however health guidelines and precautions must be taken (such as face coverings).

Nonetheless, the risk of a second wave will clearly remain high and if cases do surge again, the government would be in a tough position given the hit to real GDP and public finances this year- it may be reluctant to introduce full lockdown measures straight away

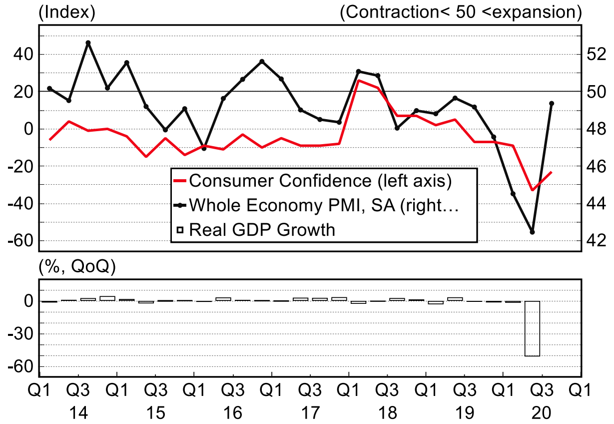
Under the current baseline, we expect the recovery to remain gradual. Public mobility indicators show that a return to ‘normality’ remains a distant prospect, with movements at workplaces, retail and recreation locations still well below the pre-virus baseline. Meanwhile the economic backdrop remains fragile, the whole economy PMI remained below 50 in September, suggesting contraction, and consumer confidence indicators remain markedly weaker than at the start of the year.

Consequently, the final figure for real GDP in 2020 is expected to be dire, even after a mechanical pick-up in GDP in Q3 as lockdown measures were eased. The South African Reserve Bank (SARB) has just downgraded its forecast to -8.2% from -7.3% YoY, in line with the IMF (-8.0% YoY). Growth from this low level of output next year is set to be limited. The IMF has lowered its forecasts for 2021 by 0.5 percentage points to just 3.0% YoY. It looks

[2] Eskom (the national power company) has suffered from a number of issues from major governance and technical weakness, declining electricity demand, unstable revenue sources to rising costs, which has led to load shedding. Meanwhile, South African Airways is looking for a bailout and has suspended all operations.

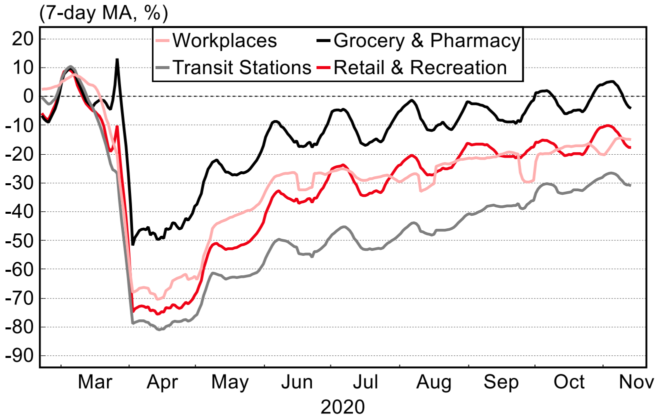
likely to be a long road back for the South African economy, with output set to remain below the pre-virus level for several years to come.

Survey Indicators and Real GDP



Source: BER, Macrobond, MUFG Bank Economic Research Office

Mobility, Length of Stay, Compared to Baseline



Source: Google LLC "Google COVID-19 Community Mobility Reports". https://www.google.com/covid19/mobility/ Accessed: 28th Oct, Macrobond, MUFG Bank Economic Research Office