Special Report

South Africa: Sharp recession inevitable despite relatively limited coronavirus spread

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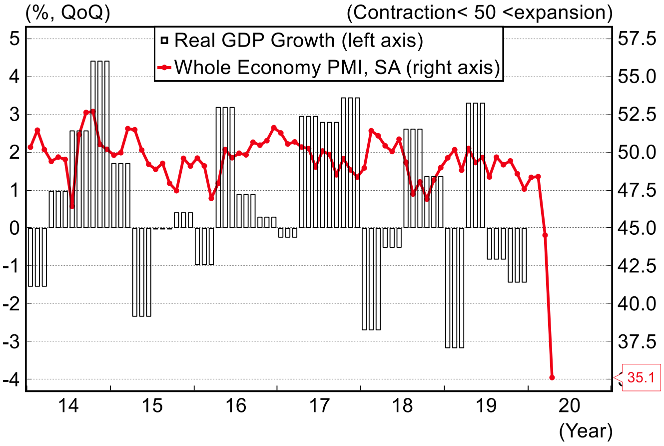
Introduction

The spread of coronavirus in South Africa and its impacts have added to recent economic weakness. In 2019, the South African economy grew just 0.2% YoY, as a result of persistent subdued private consumption, and weakness in both the mining and agriculture sectors. After two negative quarters at the end of 2019, the recession is set to deepen, due to the impacts of coronavirus and containment measures. This is despite the relatively small number of confirmed cases in South Africa so far (just over 11,000 versus 4.2 million cases worldwide).

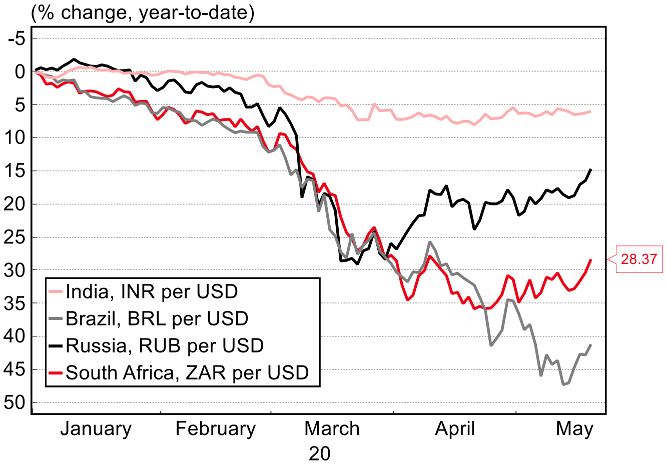
Coronavirus impacts initially led to a sharp drop of the 'Whole economy PMI' from March this year, with subsequent containment measures (a 21-day national lockdown started on 26th March) now set to further impact both domestic demand and investment too. Containment measures are designed to contain the spread of the virus domestically and prevent a sharper longer term economic slump, but economic survey/sentiment indicators and the South African Rand have weakened sharply. In fact, year-to-date, the Rand has been one of the worst performing currencies, among major developing countries.

Real GDP Growth and Whole Economy PMI



Source: Macrobond, IHS Markit, MUFG Bank Economic Research Office

FX Spot Rates Since Jan 1st 2020



Source: Macrobond, MUFG Bank Economic Research Office

A recovery is expected towards the end of 2020, as the effects of containment measures on private consumption begin to wear off, but the outlook remains uncertain. Authorities have rolled out fiscal and monetary measures to contain the economic shock, alleviate its impacts and support the recovery. However, these same measures could now further exacerbate underlying weaknesses in public finances. Furthermore, the spread of coronavirus has not yet been contained globally, so risks will remain to the downside and subject to great uncertainty.

Policy Response & Public Finance Concerns

While the South African Reserve Bank (SARB) has reduced its main policy rate, the repo rate, by 100 basis points to 4.25% on the 15th April, the South African government has announced the introduction of a fiscal package worth USD 26 billion (10% of GDP). The package includes funds to be used to protect jobs and businesses (via a loan guarantee system) and increase social welfare, and will be funded through a mixture of expenditure redirection, as well as increased borrowing from domestic and external sources. The government has asked the IMF, World Bank and a number of development banks for external funds.

However, given the increase of government debt to fund the fiscal package, existing concerns over the deterioration of public finances, in particular, the trajectory of public debt, could be heightened.

Leading into the crisis, South Africa's public finances have been persistently weak, primarily due to low real GDP growth. In fact, the government debt ratio had already doubled since 2008, standing at 66.2% of GDP at end-2019, and was on a firm upward trajectory together with interest payments (4.1% of GDP in 2019, or around 14.2% of total government revenues). Now, given the likely impacts of coronavirus, the domestic and global economic recession, as well as lingering difficulties at the South African Revenue Service (SARS)[1] and state owned entities, such as Eskom[2] , fiscal risks have undoubtedly risen from earlier in the year.

Indeed, the trajectory of general government debt (as a % of GDP) is now expected to worsen. Before the onset of the coronavirus pandemic, government debt was forecast to reach 64.2% of GDP this year by the IMF, but this will now certainly be higher. Worryingly, the government fiscal deficit could reach up to 12.0% of GDP this year. Added to this, non-resident holdings of government debt have also continued on their long downward decline and now stand at 33.3% of total government debt, from 42.3% at end- 1Q 2018, which suggests greater foreign investor unwillingness to hold South African government debt. The benchmark 10-year government bond yield also spiked in April this year, and remains elevated at 8.9%, despite slowly reverting back to its mean, perhaps bolstered by the SARB's own bond-buying program to support the secondary government bond market, announced at the end of March this year.

Although, while we do note fiscal risks have undoubtedly risen, they will be mitigated in the most part by large rand denominated government debt (89.2% of total government debt in 2019) and average government debt maturity (14.9 years as of 2019) which reduces both FX and rollover risks. Moreover, with regards to a potential IMF program, authorities have also

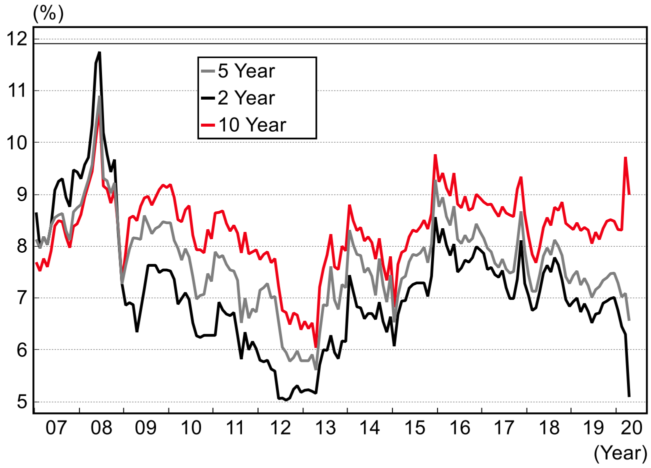
[1] State capture of the SARS, has led to weaker government revenues (and in turn fiscal outcomes), and procurement issues, which has hurt confidence and increased uncertainty.

[2] In recent years, Eskom (the national power company) has suffered from a number of issues including major governance and technical weakness, declining electricity demand, unstable revenue sources and rising costs, according to the IMF. Due to the strategic importance of Eskom, the government has had to provide fiscal support. Weakness at the power utility has led to load shedding which has had a major negative impact on economic growth.

made clear that they will not look towards a normal conditions based program. Naturally, given considerations over rising government debt levels, authorities want to borrow as much as possible on favourable terms (i.e. lower interest rates than commercial debt and longer maturities) from both the IMF and other development banks, in order to contain fiscal risks.

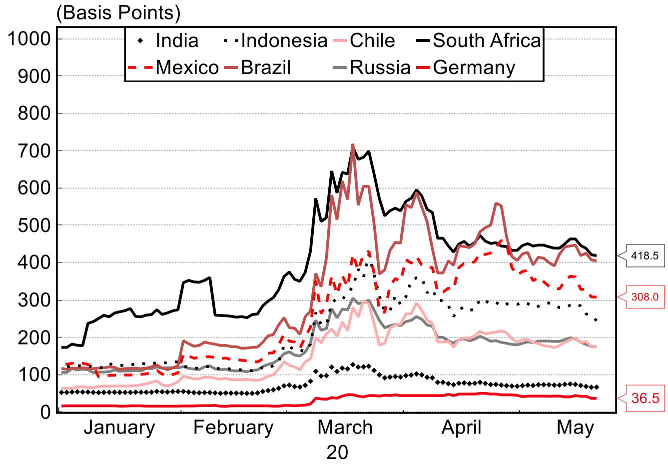
Altogether, at present the real issue does not look to be so much the increase of fiscal risks in the near term, which for the most part, look to be contained for now (although we note subject to uncertainty from both coronavirus, and the materialisation of external funds), but the trajectory and management of these risks over the next few years. However, we do caution if the impacts of coronavirus on real GDP growth and public finances are greater than the current baseline suggests, risks could rise much faster in the near-term. In terms of the materialisation of external funds from the IMF and others, this will also have to remain monitored. Further ahead, a second wave of infections as containment measures are eased is also a clear risk.

Government Bond Yields



Source: Macrobond, MUFG Bank Economic Research Office

USD, 10 Year CDS



Source: GFI Group, Macrobond, MUFG Bank Economic Research Office

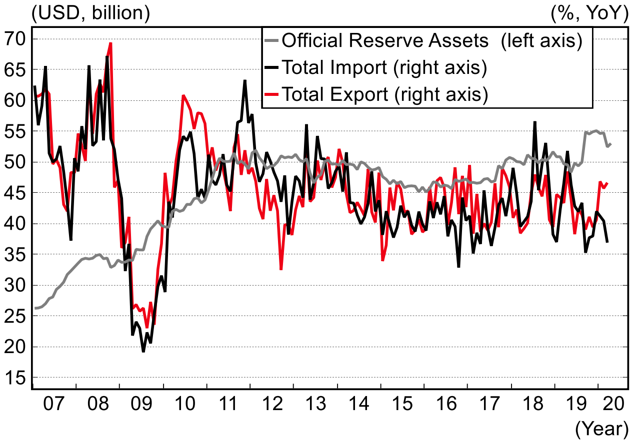
Current Account Deficit Likely to Improve in 1H 2020

South Africa's current account deficit (CAD) is likely to improve over the first half of this year due to significant import contraction as a result of the impacts of coronavirus and containment measures on private consumption, as well as the effects of the large exchange rate depreciation on both imports and exports. Additionally, the decline of non-resident holdings of government debt is likely to lead to a smaller primary income deficit. In turn, this could reduce South Africa's reliance on volatile portfolio funds, to fund the CAD. Indeed, latest monthly import and export figures suggest net exports improved in 1Q 2020, with 2Q data likely to highlight the full effects of containment measures. The outlook for 2H 2020 remains dependent on the lifting of coronavirus lockdown restrictions and the response from private consumption.

However, despite a potential reduction of the CAD, some risks will remain. Portfolio flows will remain subject to both current global risk-off sentiment and the rise of idiosyncratic risks (trajectory of public finances), and will need to remain monitored.

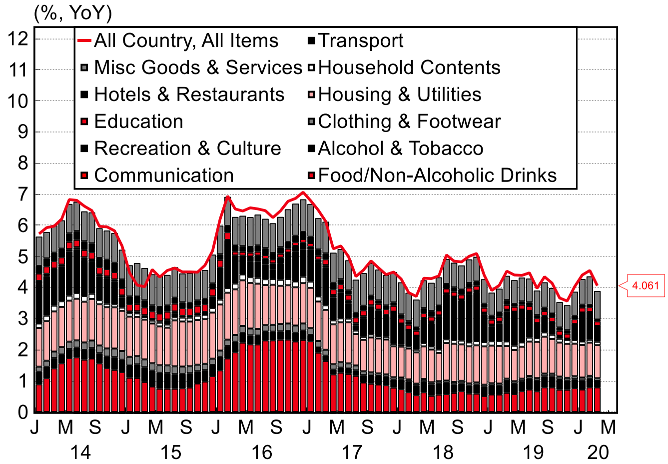
Moreover, additional monetary policy rate cuts (if needed to support the economy) on top of the recent reduction of the repo rate, by 100 basis points to 4.25% on the 15th April, could also have ramifications for inflows attracted by relative real interest rates. We note, while there has been significant exchange rate depreciation, the exchange rate pass through to inflation should be limited, but the risk remains that it could be greater. In fact, the SARB had been expecting inflation to pick-up from 4Q 2020.

Official Reserves, Imports & Exports



Source: SARS, IMF IFS, Macrobond, MUFG Bank Economic Research Office

Consumer Price Index



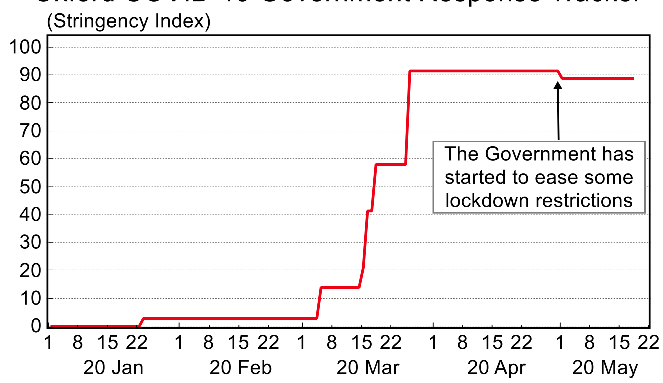
Source: Stat SA, Macrobond, MUFG Bank Economic Research Office

Outlook: Risks Skewed to Downside

All-in-all, given the fiscal and monetary policy response, and ongoing containment measures, South Africa's real GDP is set to fall sharply this year. Initially, the coronavirus outbreak affected global supply chains, now the subsequent effects of containment will weigh heavily on private consumption and investment. The IMF forecasts real GDP growth of -5.8% YoY in 2020 before recovering to 4.0% in 2021. Risks are expected to remain firmly to the downside over this forecast horizon, and we have concerns over the speed of the recovery in 2021. In fact, it is probably too early to predict such a strong recovery (despite base effects).

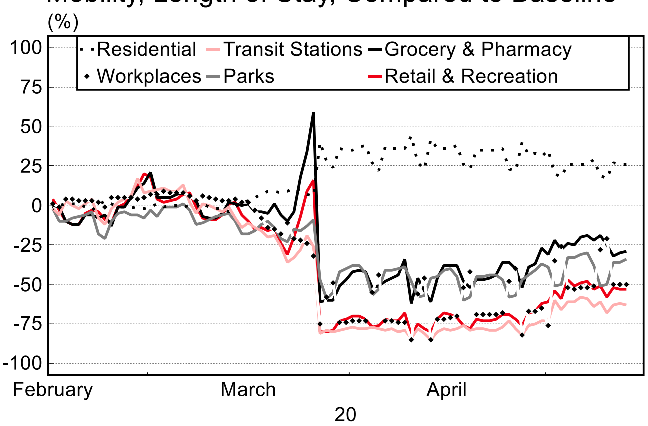
Accordingly, we will continue to monitor survey indicators, real GDP, and confirmed coronavirus case figures throughout 2020. In the short-term, high frequency mobility data will show how quickly activity recovers now that the government has begun to ease virus containment measures.

Oxford COVID-19 Government Response Tracker



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

Mobility, Length of Stay, Compared to Baseline



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