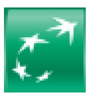

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1 April 2020

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# South Africa: Extraordinary times

## KEY MESSAGES

We have revised down our 2020 GDP forecast for South Africa further and now expect a 4% growth contraction versus -1.2% previously.

The Covid-19 pandemic is likely to severely hurt supply and demand channels. The latter particularly exacerbated by a three-week lockdown, which we deem a minimum requirement.

We expect the Treasury to revisit its fiscal framework in the coming months; a budget deficit of 9.1% of GDP for FY 2020-21 is now our base case.

While the SARB has announced measures to improve liquidity and market function, more action will likely be required as the debt service burden balloons on another inevitable ramp up in local bond issuance.

While we do not foresee an imminent IMF programme, we think it possible for the country to approach external sources for targeted financing as it looks to try and contain fiscal damage in FY 2020-21.

Adjusting prudential regulations is an avenue that could be explored, though it could be seen as a first step towards a less palatable prescribed assets policy, and therefore unlikely (right now), we think.

## MARKET VIEW

The market is underestimating the possibility of lower for longer interest rates in South Africa, in our view, and we remain positioned in ZAR 2y swap receivers.

The reversal of easing embedded in the FRA curve after nine months is ambitious, considering persistent supply-side constraints. Low policy rate pass-through to FX implied yields supports further SARB easing to tackle the real economy.

We see scope for further compression in front-end rates, even considering that we took partial profits on the trade (78bp), see *ZAR rates: Take partial profit on 2y receiver*, published on 24 March 2020.

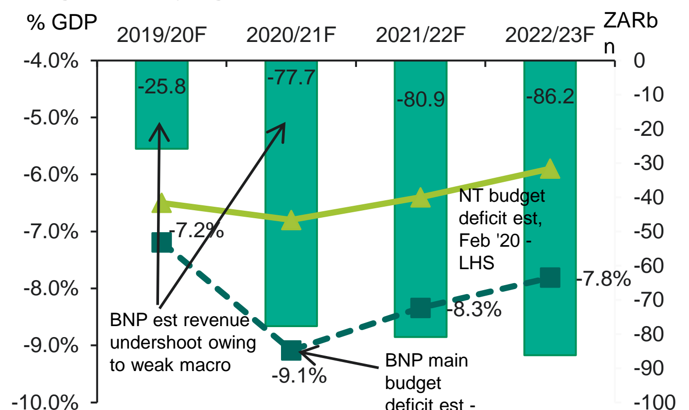
**Much deeper recession now expected:** South Africa's growth headwinds have soured further as the impact of the Covid-19 pandemic on global economic activity becomes clearer and the country entered a 21-day lockdown from 27 March.

Our expectation for a more substantial change in consumer behavior and demand and a sharp deceleration in investment, which could last well beyond the end of the lockdown, has prompted us to further downgrade our GDP forecasts. We now expect the economy to contract 4.0% in 2020 (-1.2% prior), which is 2.5pp lower than the growth contraction recorded in the wake of the 2008-09 global financial crisis.

We see GDP picking up towards 2.0% in 2021, though mainly on base effects and acknowledging the risk that the slowdown in global activity lasts longer as it takes time for consumer behavior to normalize and global value chains and companies to rebuild themselves.

A much sharper growth contraction in 2020 translates into significantly larger headaches for government revenues, fiscal deficits and sovereign debt (Figure 1).

**Fig. 1: Sharply higher deficits as revenues are set to slide**




*Sources: National Treasury, BNP Paribas forecasts*

Jeffrey Schultz, Senior Economist | BNP Paribas South Africa Branch | Shaun Daly, CEEMEA strategist | BNP Paribas London Branch

# Fiscal denominator and debt service headaches

Strongly negative growth in 2020 means that South Africa's fiscal problems are set to become worse.

**We forecast nominal GDP of just 0.2% in 2020:** Our forecast is based on our tweaked view for CPI inflation to average just 3.5% in 2020 from an already sub-consensus 3.8%. Our revised forecasts have far-reaching implications for fiscal deficit and debt trajectories.

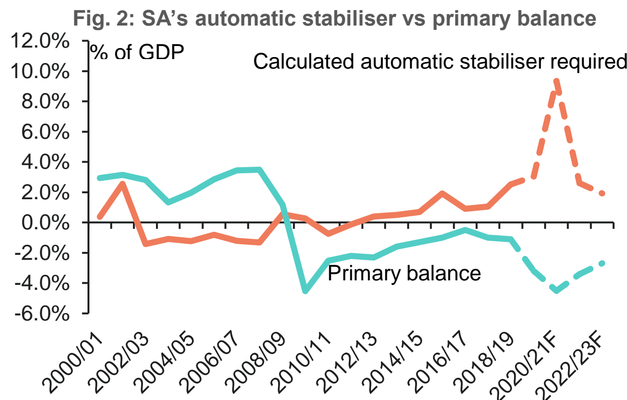
**Big revenue undershoots:** We estimate nominal revenues to undershoot the Treasury's February budget forecasts by ZAR245bn (4.5% of GDP), cumulatively over the coming three years and nominal GDP to slide and tax buoyancy to falter further on the country's mooted support plans to defer VAT and PAYE receipts for some small, medium and micro-sized enterprises (SMMEs) – figures that undoubtedly underpinned Moody's largely anticipated sovereign downgrade (Ba1) and maintenance of a negative outlook last Friday.

**Record high budget deficit in FY 2020-21:** For FY 2020-21, we estimate the main budget deficit to touch a record high of 9.1% of GDP compared with the 6.8% shortfall the Treasury had forecast in this year's budget and the 7.2% GDP shortfall we now expect for FY 2019-20. We expect the deficit to then gradually narrow to 7.8% of GDP by FY 2022-23 compared with the 5.9% deficit the Treasury had previously forecast. It should be noted that we do not expect much additional fiscal spending measures to be adopted. Most of the Covid-19 fiscal support is likely to come from reprioritizing existing expenditure budgets. This is a further risk to the deficit trajectory should things worsen.

These numbers are consistent with a sharp widening in the primary deficit to 4.5% of GDP in FY 2020-21 from an estimated 3.2% shortfall in FY 2019-20, narrowing to a 2.7% deficit by FY 2022-23. For FY 2020-21 this means a strong spike in the country's automatic stabilizer required to contain sovereign debt. The latter, we now think is likely to spike to 72.2% of GDP in FY 2020-21 from 63% in FY 2019-20.

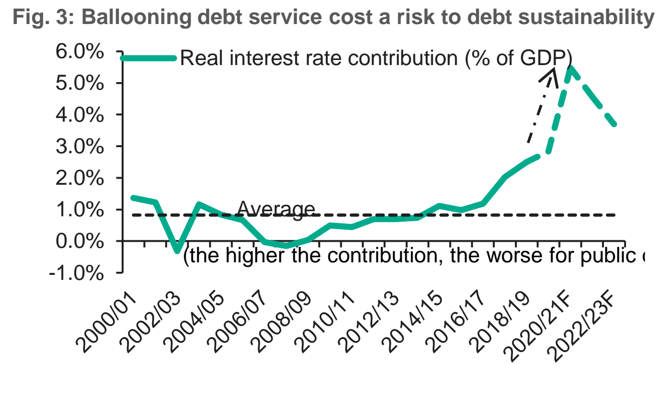
**Spike in funding costs:** One of the biggest problem the Treasury faces is the sharp spike in funding costs, which have on average risen 250bp since the budget was tabled on 26 February. Our automatic debt dynamics model indicates that approximately 60% of the 9.3% of GDP automatic stabilizer required in FY 2020-21 can be attributed to ballooning debt service costs, followed by negative GDP growth (27%) and the smaller residual owing to weaker FX, thanks to South Africa's still low levels of hard currency debt stock (10% of total). The latter remains an important cushion given the stark FX weakness in recent weeks (see EM – Harbingers of FX and rollover risk, published 24 March).

**Fig. 2: SA's automatic stabiliser vs primary balance**



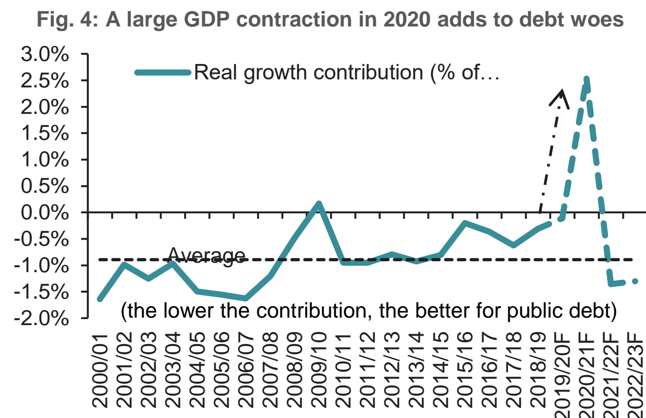

*Sources: National Treasury, BNP Paribas calculations and forecasts*

**Fig. 3: Ballooning debt service cost a risk to debt sustainability**



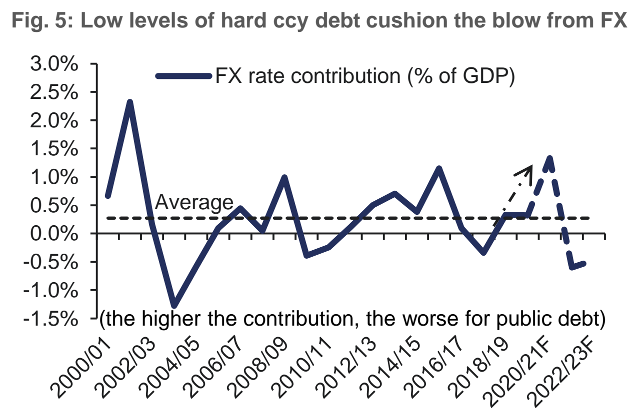

*Sources: Sources: National Treasury, BNP Paribas calculations and forecasts*

**Fig. 4: A large GDP contraction in 2020 adds to debt woes**




*Sources: National Treasury, BNP Paribas calculations and forecasts*

**Fig. 5: Low levels of hard ccy debt cushion the blow from FX**




*Sources: National Treasury, BNP Paribas calculations and forecasts*

Jeffrey Schultz, Senior Economist | BNP Paribas South Africa Branch

# It's not business as usual...

While the higher debt service cost has partly been exacerbated by poor liquidity and global recession expectations, the anticipation of much higher deficits leading to another steep jump in Treasury issuance of SAGBs and a sharp rise in sovereign debt ratios have also led to the spike in yields.

**Large ramp up in local issuance is coming:** The Treasury has indicated that it is only likely to announce changes to its weekly issuance schedules in the weeks after after the country has emerged from its three-week lockdown period (scheduled to end midnight, 16 April).

Our estimates suggest that weekly issuance could jump as much as ZAR1.5-2.0bn (35-40% increase) based on our revised macro and fiscal trajectories. With South Africa's yield curve already one of the steepest globally, we feel that a stronger rethink of its issuance strategy towards shorter maturity bonds and perhaps more T-bill issuance is plausible.

Our CEEMEA strategy team's positioning analysis already highlights that the Treasury has been gradually issuing shorter maturity bonds, though arguably a more aggressive strategy to shorten the maturity profile of new issues will potentially have to be pursued, we think. Our expectation for the SARB to still deliver an additional 75bp in rate cuts this year (see SARB - Bigger cut now, more measured ones later, published 19 March) could also help if such a strategy is adopted, we think.

**Additional policy action may be required:** The SARB's recent decision to purchase SAGBs in the secondary market to help improve liquidity and market access (size, maturity and longevity of purchases at its discretion) highlights the concern among policymakers to ensure adequate access to funding in what has (prior to this week's better supported bond auction), been relatively lacklustre demand – particularly given healthy real yields on offer.

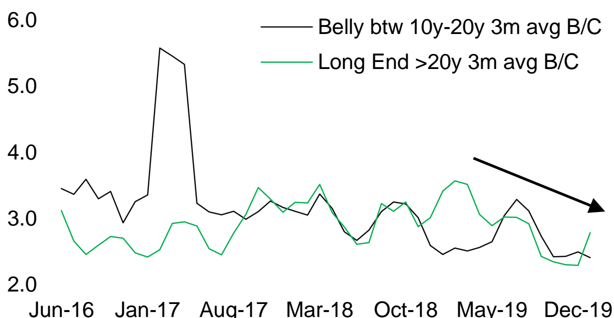
However, the inevitable event of the Treasury having to significantly step up weekly issuance means that we are not yet convinced that current market dynamics would be able to soak up coming additional supply.

**Tapping global lenders of last resort?** We would, therefore, not be surprised to see the Treasury and SARB approach global lenders such as the IMF (for its 'Rapid Financing Instrument') to try and access shorter maturity funding at more palatable interest rates. While historically we have argued that the ruling ANC would steer clear of approaching such organizations for fear of losing its 'sovereignty, these are extraordinary times. If the Treasury is able to tap global lenders of last resort without having to opt for a full-fledged IMF programme (therefore, devoid of the strong economic reform conditionality that go along with it), we think that there is a good chance policymakers will explore these avenues in the coming months – this is backed by comments from the SARB and National Treasury this past weekend.

**Amending prudential limits, a possible step too far?** There are some regulatory controls that the SARB and National Treasury could consider in the event that the domestic funding situation gets progressively worse, we think. These could include adjusting the prudential limits of the country's banks, pension funds and asset managers temporarily to force some repatriation of offshore capital towards SAGBs (for instance, many pension funds, we believe, utilize most of their 30% offshore investment allowance).

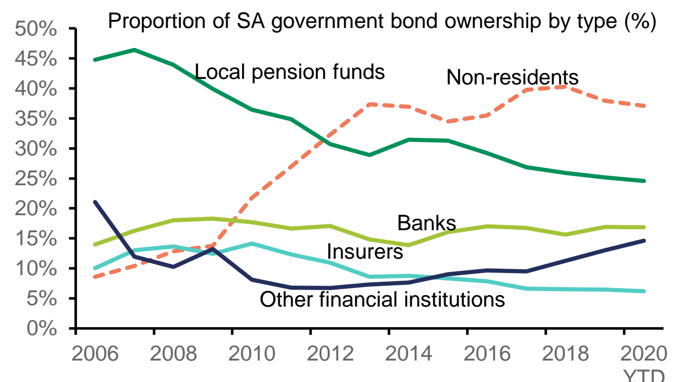
However, the read-through to a politically contentious 'prescribed assets' policy and return to more draconian capital controls, at this stage at least, is a double edged sword for a country running twin deficits and heavily reliant on external funding which risks being crowded out in such a scenario. Therefore, such a decision is unlikely to be taken lightly and one that policymakers most likely want to avoid for as long as they can. In the context of the uncertainties and unprecedented economic and fiscal challenges the country faces though, never say never.

**Fig. 6: SAGB auction performance – more pain to come?**




*Sources: National Treasury, BNP Paribas calculations*

**Fig. 7: SAGB ownership trends**




*Sources: National Treasury, BNP Paribas*

Jeffrey Schultz, Senior Economist | BNP Paribas South Africa Branch

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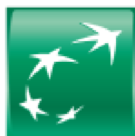

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