South Africa

Economic costs of COVID-19 mount (Erratum)

This report supersedes the report published earlier on 22 May and includes our correct repo rate forecasts for 2022 and 2023.

- **We are revising our 2020 GDP growth forecast lower.** We now expect GDP to contract by 9.7% in 2020, with an incomplete recovery of 3.1% in 2021, compared with our previous forecasts of -6.4% and 2.8%. Since we published the *Q2 20 South Africa Quarterly Perspectives* on 16 April, various domestic and global developments have pointed to a deeper recession this year. In particular, the government's risk-adjusted framework for easing the lockdown places more limitations on economic activity and movement of people beyond end-April than we had expected. It will likely take several years for South Africa to regain its 2019 GDP level, and its sectoral composition will shift.

- **The government's stimulus package will help soften the blow.** The government's R500bn response package (equivalent to c10% of GDP) is in our view more 'relief' than 'stimulus', since R200bn is a guarantee programme, while R130bn is a reallocation from within the existing budgetary envelope. Thus, we believe it will help ease the economic damage somewhat but not prevent an unprecedented economic contraction in the near term.

- **The current account will move closer to balance.** Terms of trade gains, as well as strong import compression, will see the current account deficit narrow a lot. This will mitigate some of the currency risk, though portfolio capital flows will also remain key. We still forecast the rand at 16.40 to the USD by end-year.

- **Public finances will come under even more pressure.** We expect the main budget deficit to hit 16.2% of GDP in FY2020/21, sending debt soaring to 84% of GDP, due to collapsing tax receipts and the costs of the government's economic response package. Stronger growth is the only solution to South Africa's unsustainable debt dynamics, but some fiscal tightening will also be necessary once the pandemic is over.

- **After the MPC cut by 50bp this week, we are pencilling in a further 50bp of easing into our baseline forecast.** This is largely because we believe the GDP outlook is worse than the SARB currently forecast, while the CPI outlook is softer, creating both need and scope for further easing. This new 50bp cut could come as early as the July MPC if the activity data over the next two months look weak.

- **Risks remained skewed to the downside.** As the world continues to learn and respond to the COVID-19 pandemic in real time, the risks seem tilted in the direction of a more prolonged pandemic and lockdown restrictions, implying even more negative economic outcomes. Our downside risk scenario to our baseline forecast has GDP contracting 12.3% this year, with the rand hitting 19.20 per USD by end-year. We would expect this to elicit a further 150bp of easing from the SARB on top of the 50bp in our baseline.

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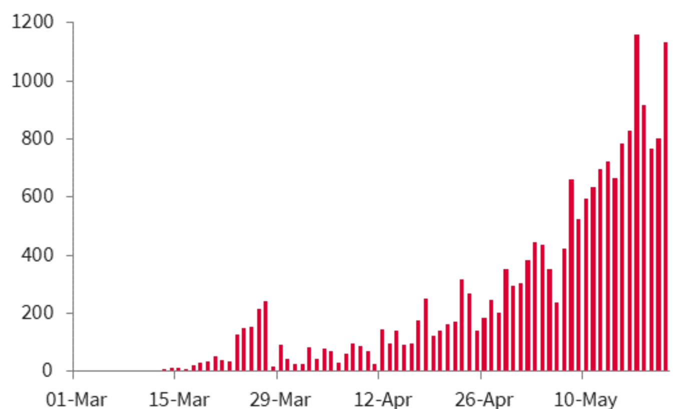
A lot has changed over the last month since we published our forecast update. While some countries have begun to relax social distancing as they gain some measures of control over the public health aspects of the pandemic, the economic outlook has deteriorated

A lot has changed since we updated our macroeconomic forecasts in the *Q2 20 South Africa Quarterly Perspectives* report published on 16 April. The COVID-19 pandemic continues to spread around the world, causing not only a devastating blow to economic activity, but also loss of life. At the time of writing, over 330,000 COVID-19-related deaths had been reported worldwide, a number that seems set to increase as confirmed positive cases rise. Countries have responded with different versions of lockdown relaxations as they gain some control over public health aspects of the pandemic. However, there is growing recognition that the economic damage caused by the pandemic is going to be larger than initially expected. For instance, the IMF recently said that economic data had come in weaker than it expected on 6 April when it published its projection of a global contraction of 3% for this year, and that weaker scenarios might materialise. Most forecasters around the world have been revising their forecasts downwards.

New confirmed infections continue to mount in South Africa, but interpreting the significance of this trend is challenging

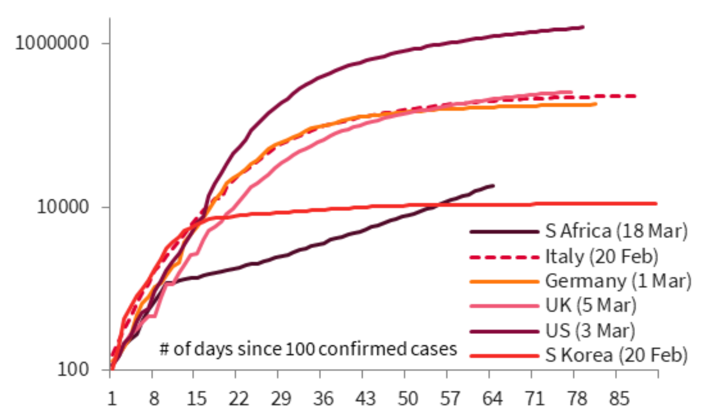
In South Africa, more recent data suggest growing difficulty in containing the spread of new infections, despite some apparent early success and one of the most stringent lockdowns globally. The number of confirmed positive cases has more than doubled in the past two weeks alone (Figure 1). A part of this seems to be the improved testing capacity, with the daily number of tests now averaging 15-20k. However, the number of positive cases as a proportion of the total daily tests has risen slightly in recent days, suggesting that new infections may be spreading faster. There has not been a comprehensive update on preparedness of public health facilities to manage a much larger outbreak. However, on the current trajectory, it appears that the worst of this pandemic still lies ahead for South Africa. The government has said it expects infections to rise sharply and peak over the coming winter months.

Figure 1: South Africa's daily number of confirmed cases has risen…



Source: Department of Health, Absa Research

Figure 2: …keeping the overall curve of total cases on a rising slope



Source: John Hopkins University, SA Department of Health, Absa Research

The risk-adjusted framework to easing lockdown restrictions continues to place significant limitations on economic activity and movement of people

While there is uncertainty about how long the COVID-19 pandemic will last, the economic outlook has continued to deteriorate since we published the last *South Africa Quarterly Perspectives* report due to several factors. The first and perhaps most important is that the government's risk-adjusted framework for easing lockdown restrictions places more ongoing limitations on economic activity and the movement of people beyond end-April than we had initially expected (Figure 3). Since the adoption of the five-level alert system towards the end of April, the government has placed the country on Stage 4, which maintains many of the restrictions on economic activity from the hard lockdown, including on retail and manufacturing activity. However, the situation remains in flux, with President Ramaphosa last week announcing some tweaks to the Stage 4 rules, which allow a greater range of retail activity, including ecommerce. Ramaphosa also suggested the country would likely be moved to Stage 3 at the end of the month, but this depends on progress in the fight against the spread of COVID-19.

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Figure 3: Economic activity remains severely restricted as the government implements its risk-adjusted lockdown framework

Stage	Activity allowed by government regulation
5	Only essential services
4	Manufacturing of autos phased up to 50% employment, cement and construction material to 50% and others to 30% Food retail to sell full product line; Hot cooked food for home delivery Sale of winter clothes allowed All agricultural production, processing and exporting Mining: open cast at 100%, others at 50% Restaurants only for food delivery Essential imported goods to be prioritised through ports
3	Most manufacturing scaled up to 100%, though some limited to 50% Alcohol retail and off-premise consumption; clothing retail allowed Motor vehicle sales Commercial building projects; commercial real estate permitted Limited domestic air travel Mining scaled to 100%
2	Construction, including private residential All other retail All other manufacturing All manufacturing scaling up to 100% employment All retail permitted, subject to directions All automobile repairs
1	Most sectors allowed to resume with health guidelines

Source: South African Government, Absa Research

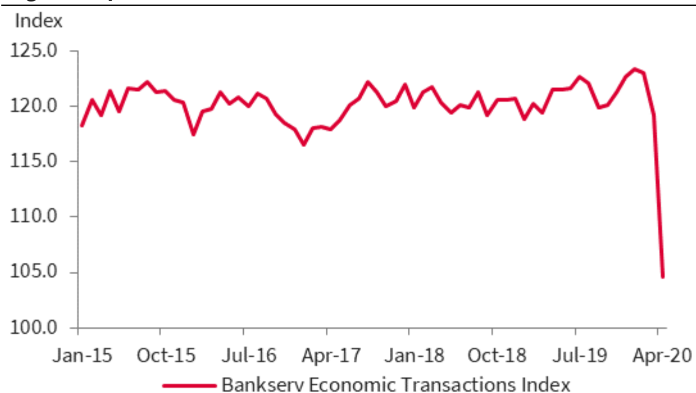
There is growing anecdotal evidence of business closures and job cuts

There has been little new official data since our April macro forecast but anecdotal evidence of business failures and job losses is growing and there are reports of growing consumer strain. For instance, a Stats SA COVID-19 Business Impact survey carried out from 14 to 30 April and published on 14 May shows that 8.6% of the 2,182 businesses polled across different parts of the economy had already permanently shut down, while 45.6% reported that they expected to reduce their workforce in the two weeks after the survey reference period, while nearly 9 out of 10 surveyed businesses said their turnover was below normal. There have also been various instances reported in the press of major businesses that announced significant losses in revenue and applied for various lines of funding assistance.

Recent high frequency data suggest that activity was weak in April but improved over the course of the month

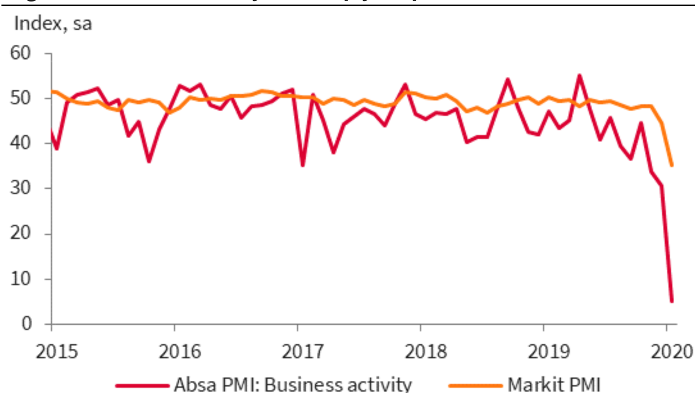
Unsurprisingly, most of the available non-governmental activity-related data from April show a huge negative effect from the first month of the lockdown. Absa Research recently launched an Economic Activity Tracker to help investors monitor, in a 'nowcasting' fashion, what is happening with the economy. Particularly notable, in our view, is the fact that the Bankserv Economic Transactions Index (BETI) recorded its largest ever monthly drop of 12.2% m/m (Figure 4). Purchasing managers indices also point to a big blow to activity in April (Figure 5), as does Eskom's weekly data on electricity demand, although, interestingly, the data show an improving trend throughout the month of April and into May, perhaps suggesting that some economic participants were learning to adapt to the lockdown restrictions (Figure 6). Google mobility data also suggest an improving trend over the course of April and into May (Figure 7). Of course, these data provide only a partial insight into activity levels recently, and uncertainty about the future remains high.

Figure 4: April saw a record contraction in bank transactions



Source: Bankserv, Absa Research

Figure 5: Economic activity fell sharply in April under the hard lockdown



Source: BER, Markit, Absa Research

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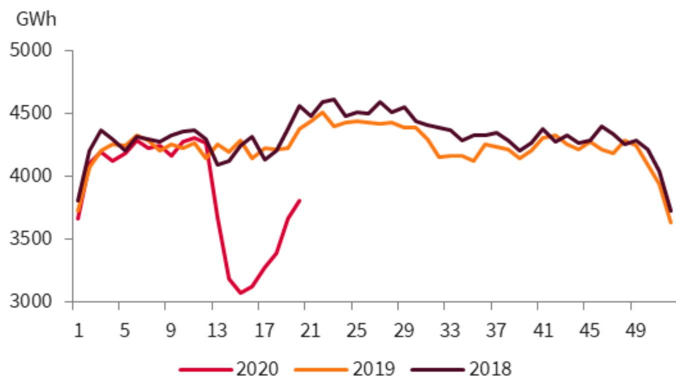
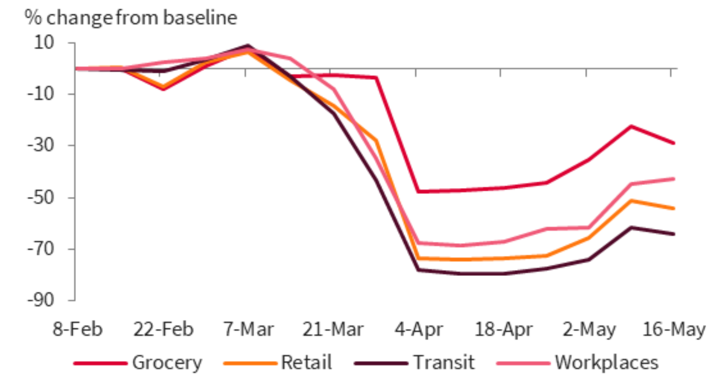
Figure 6: Electricity demand rising as lockdown restrictions are eased



Source: Eskom, Absa Research

Figure 7: Movement to workplaces and retail down sharply



Source: Google, Absa Research

The government's economic response will provide some relief but the lockdown impact is still likely to dominate

A major counterbalance to the negative impact of the COVID-19 pandemic is the government's announcement of a R500bn economic relief package. Although the headline amount of the package seems large, at about 10% of GDP, a closer look shows that the net increase in government expenditure will be a lot smaller. Of the R500bn, R200bn is a loan guarantee scheme, half of which the government has already activated, with qualifying firms able to access funding from 12 May. A further R130bn of the package will come from expenditure reprioritisation. About R70bn is temporary tax relief through deferrals of PAYE and provisional corporate income tax, most of which the government still aims to collect after six months. Nonetheless, the near-term liquidity support should still be a welcome relief for many companies struggling to generate revenue under the lockdown restrictions. However, we believe that the effect of continuing restrictions will more than dwarf the beneficial effect.

In the absence of new macro data for a model run, we have approached our forecast revision process from the supply side of the economy

Modelling the economic impact of this complex health shock, which has mutated into a supply shock, a demand shock and a financial shock, is a difficult exercise and implies a high degree of uncertainty to any point forecast. With this latest report, we outline what we believe is a plausible scenario in light of the continuing stringent restrictions. In the absence of new quarterly macro data to run our demand-side macroeconometric forecasting model, we have again begun by looking at the supply side of the economy, quantifying possible impacts across the different sectors of the economy.

Figure 8: A sharp contraction in economic activity in 2020 seems unavoidable for South Africa

	Real GDP, level index, Q4 19 = 100								Real GDP, % y/y	
	Q1 20	Q2 20	Q3 20	Q4 20	Q1 21	Q2 21	Q3 21	Q4 21	2020	2021
Agriculture, forestry and fishing	101.2	108.1	115.4	119.5	118.0	116.5	115.0	113.5	8.4	4.2
Mining and quarrying	97.4	68.9	89.1	90.2	91.3	92.4	93.5	94.7	-13.1	7.6
Manufacturing	97.3	65.1	81.0	83.0	85.0	86.0	87.1	88.1	-19.1	6.1
Electricity and water	99.2	96.3	97.2	97.7	98.4	99.2	99.9	100.6	-3.6	2.0
Electricity	98.8	94.8	96.0	96.5	97.3	98.2	99.0	99.9	-4.6	2.1
Water	100.4	100.7	101.1	101.5	101.9	102.3	102.6	103.0	-0.3	1.5
Construction	96.0	45.4	54.0	58.7	60.1	61.6	63.1	64.6	-37.8	-1.9
Trade and accommodation	99.0	58.3	84.4	85.8	87.0	88.1	89.2	90.4	-18.3	8.3
Wholesale	100.7	69.8	91.8	92.9	94.1	95.2	96.4	97.6	-11.3	7.9
Retail	100.7	60.5	88.1	89.2	90.3	91.4	92.5	93.6	-15.5	8.7
Motor trade	89.1	33.5	67.0	70.1	71.8	72.7	73.6	74.5	-35.2	12.7
Catering and accommodation	98.7	31.2	48.9	50.6	53.0	54.2	55.5	56.9	-42.8	-4.3
Transport and communication	98.4	96.1	98.4	99.9	100.8	101.8	102.7	103.7	-3.9	4.1
Transport	97.4	89.1	91.2	92.8	93.5	94.2	94.9	95.6	-9.3	2.0
Communication	100.5	111.2	113.9	115.3	116.7	118.1	119.6	121.1	7.9	7.8
Finance, real estate and business services	98.7	90.3	91.5	91.8	92.3	92.6	92.9	93.2	-6.0	-0.4
Finance and insurance	99.5	95.5	95.5	95.5	95.8	96.0	96.3	96.5	-2.5	-0.4
Real estate	96.9	79.3	83.9	84.9	86.0	86.6	87.0	87.4	-12.9	0.6
Business services	99.2	92.4	92.4	92.4	92.6	92.8	93.0	93.3	-5.0	-1.2
Personal services	99.2	85.5	90.4	91.5	91.9	92.4	92.8	93.3	-8.2	1.1
General government services	100.2	100.5	100.5	100.5	100.5	100.5	100.5	100.5	0.9	0.1
Total value added at basic prices	98.7	81.4	90.3	91.4	92.2	92.8	93.5	94.1	-9.7	3.1
GDP %y/y	**-1.0**	**-19.1**	**-10.0**	**-8.6**	**-6.6**	**14.1**	**3.5**	**2.9**	**-9.7**	**3.1**

Source: Stats SA, Absa Research

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Agricultural sector should still do well but mining likely to fall sharply

In the primary sector, our view on agriculture is broadly unchanged. The sector appears likely to have a strong year, with the Crop Estimates Committee recently revising up its projections for the 2020 summer crop. We expect the sector to record annual growth of 8.4% this year. In the mining sector, the regulations for the current stage of the lockdown indicate that a large part of the sector's productive capacity remains offline. Only coal mining firms supplying Eskom and open cast mining operations can scale up to 100% of employment capacity, while all other mining operations can resume with only 50% of employment capacity. As a result, we believe gross value added in the sector could most likely contract by nearly a third in Q2 20, before starting to recover from Q3 20. However, the recovery would likely only be partial, leaving gross value added in the sector down 13% for the year, with weaker global demand bearing down on the sector. Positively, for the sector, prices of the key export commodities have held up relatively robustly, even in a global environment of significantly weaker growth.

Manufacturing output is likely to shrink by nearly a fifth this year

Strain seems likely to deepen for the manufacturing sector. As we have noted before, the sector was already under significant pressure before the COVID-19 crisis hit. Therefore, we see elevated risks that parts of the sector's productive capacity will not be able to reboot even as lockdown restrictions are eased. Under the current Level 4 restrictions, food manufacturing, which accounts for 26.6% of total manufacturing output, is deemed an essential service and will continue to operate at 100% capacity. Other sectors that can scale up to 100% employment include the manufacturing of paper, packaging, plastic bottles, glass and fuel refineries. Vehicle and component manufacturing can only scale up to 50% employment, while the rest of the manufacturing sector can scale up to 30% of employment. While these restrictions are somewhat lighter than in the hardest Level 5 phase of the lockdown, when only essential services were allowed to continue operating, output recovery may not necessarily scale in line with the regulations, as these capacity limitations may be below what some manufacturers need to operate optimally, given operating costs. Additionally, some firms may have gone bankrupt. We, therefore, expect manufacturing output to shrink by a third in Q2 20 compared to Q1, with only a partial recovery from Q3 and Q4, such that the sector is 19% smaller this year than in 2019.

The construction sector seems likely to suffer a particularly large COVID-19 blow

The construction sector, which had big challenges even prior to COVID-19, is likely to suffer a large setback, in our view. Commercial and residential building activity will be allowed from Level 3 of the phased lock-down, but the order book of new projects seems likely to shrivel, given the smaller economy, as well as COVID-19's knock to confidence and financial health of both corporates and households. Additionally, the government's financial resources to drive big construction projects will be impaired. We expect the sector to contract nearly 38% this year.

Trade sector looks likely to recover gradually, but job losses and wage cuts are longer-term risks

In the tertiary sector, the outlook for the trade sector remains key. Outside of food retail and pharmacies, which are part of essential services, the government has allowed a gradual return of other retailers. Specifically, clothing retailers can sell 'winter clothing' under Level 4, while outlets selling computing equipment and books can also trade. Interestingly, the government also made a concession with regard to prior inexplicable restrictions on e-commerce by gazetting that all e-commerce (excluding the sale of alcoholic beverages and tobacco) can resume under Level 4 restrictions. The revisions have also included vehicles under goods that can be sold under Level 4, although we retain a gloomy outlook on the sector overall, given the knock to household incomes and confidence. Meanwhile, the hotel industry will only be allowed to operate under Level 1. While lockdown restrictions are a major challenge for the trade sector in the near term, the longer-term outlook is also clouded by the prospect of job losses and wage cuts, as a well as a lasting knock on consumer confidence. Elsewhere in the tertiary sector, the financial services, real estate and business services sector is unlikely to escape unscathed, with economic activity sharply down across the rest of the economy.

We forecast a GDP contraction of 9.7% for 2020

With all these assumptions, we now expect GDP to contract by an unprecedented 17.5%, with no annualisation in Q2 compared to Q1 (quarter-on-quarter annualised growth rates are the traditional format for reporting GDP data; however, with such large quarterly changes, annualising the changes by raising them to the power of 4 generates numbers that are hard to process intuitively, thus obscuring understanding, in our view). Forecasting the nature of the recovery is challenging in part because of the inherent uncertainty of how the pandemic will play out and how long social distancing measures will need to remain in place. It is also difficult to tell how much of

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the economy's productive capacity may close permanently. However, assuming that lockdown restrictions will continue to ease over the coming weeks and months, leaving the country operating at Level 1 and Level 2 in Q3, we believe output could rise 11% in Q3, and a little over 1% in Q4. This would leave South Africa with a full-year contraction of 9.7% for 2020.

Household consumption spending will account for much of the demand-side national accounts adjustment

On the demand side of the national accounts, we expect a big part of the decline to manifest through household consumption expenditure. In the short term, we expect a steep drop in household spending in Q2 20 and a smaller further contraction in Q3 20, given the stringent restrictions to non-essential retail activity. Further ahead, the recovery in consumption expenditure is likely to be slow, given likely significant job losses and, in some cases, pay cuts, impairing household labour income. Household investment income will also decline. However, consumer spending power will be partially boosted by rate cuts (worth R42bn over a year), as well as the R50bn expansion of social grants. We forecast real disposable income to contract by 7.0% this year, due to a combination of job losses and further downward pressure on wages. Moreover, the economic contraction is likely to significantly impair household balance sheets, with little to negative asset price growth and higher levels of indebtedness. This could also deliver a lasting blow to consumer confidence. We forecast a full-year contraction of 5.1% in household consumption in 2020 and a marginal increase of 0.8% in 2021.

Fixed investment spending is likely to grind to a near halt this year

Investment is also likely to shrink significantly this year as private sector companies shift to preserve cash reserves in the face of uncertainty. Additionally, most residential construction is likely to be on ice for a while. Meanwhile, public sector investment is also likely to be weak for an extended period amid eroded state-owned company balance sheets and a constrained fiscus. We forecast gross fixed capital formation to fall by 23.3% in 2020 and shrink further by 8% in 2021 before beginning to recover gradually in 2022. Meanwhile, given that most of the government stimulus will not come via increased spending, we expect government consumption to rise by just 0.3% this year. Some support will come from net exports. As domestic demand shrivels, we expect imports to contract by more than exports.

South Africa's rand to get some support from the current account

Terms of trade gains and import compression will deliver a stronger current account balance

The available data on merchandise trade to date suggest that South Africa recorded a current account surplus in Q1 20, the first since 2003. After adjusting for seasonal factors, South Africa reported a record merchandise trade surplus in Q1 20 (Figure 9), aided by robust terms of trade gains, with strong precious metal prices and weak oil prices (Figure 10), as well as significant import compression, probably a combination of weak demand and logistical seizure at South Africa's ports of entry as social distancing took hold. Assuming net invisible flows remain unchanged, we forecast a current account surplus of 1.7% of GDP in Q1, but the substantial portfolio sales of South African bonds and equities (Figure 12) could have helped the current account even more, and exchange rate depreciation would have boosted the rand value of South Africa's foreign income receipts, although these may have fallen in hard currency terms. The SARB will publish Q1 current account data on 2 July. PGM prices have eased in Q2, but gold has risen. The April and May data will be difficult to interpret, given ongoing lockdown restrictions, but overall, we expect the basic themes of strong terms of trade and demand-shock-related import compression outweighing the hit on South Africa's exports, and some improvement in net factor payments to strengthen the current account substantially. We now forecast a near zero balance of -0.2% of GDP this year, widening out to around -2% in 2021.

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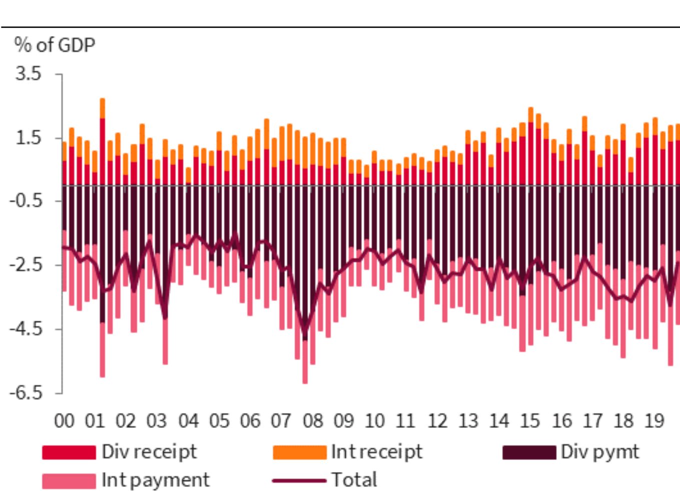
Figure 9: South Africa posted record trade surpluses in Q1 20…

Source: SARS, Absa Research

Figure 10: …due in part to rising export prices and falling import prices

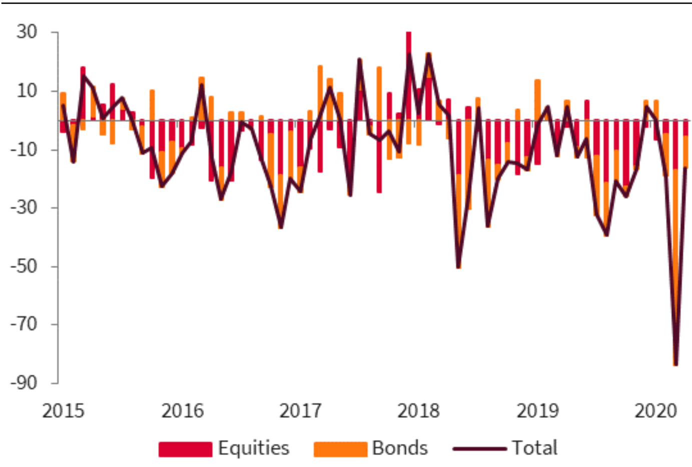
Source: StatsSA, Absa Research

Figure 11: A structural deficit on factor payments could shrink a little…



Source: SARB, Absa Research

Figure 12: …due to big bond and equity sales by foreigners over 12 months



Source: SARB, JSE, Absa Research

COVID-19 has nuked South Africa's already fragile public finances

Tax collections fell nearly 9% y/y in April

The impact of COVID-19 on South Africa's fragile public finances is devastating, both through the revenue line, as tax receipts crater, and the expenditure line, as the government struggles to keep people alive and the economy afloat. In our recent Quarterly Perspectives in mid-April, we forecast a tax shortfall (relative to the original 2020 Budget target of R209bn, which translated into a main budget deficit of 12.5% of GDP). However, speaking before the parliament in early May, SARS Commissioner Kieswetter reported that tax collections in April were 8.8% down in nominal terms. The lockdown's hit to consumer spending and imports is obviously negative for VAT collections, but the April SARS data reflect spending activity not in April but prior months. However, the hit goes beyond just spending-related taxes. Significantly, Kieswetter noted that PAYE receipts in April were 5.2% lower than the previous year, as 65,219 employers who paid PAYE in April 2019 made no payments this year, while a further 87,157 employers made smaller payments. This could imply that a lot of workers in formal economy jobs were either laid off, furloughed or experienced pay cuts in April.

The tax shortfall, relative to the original 2020 Budget target, now seems likely to be larger than we estimated just a month ago

Interpretation of the trends in the tax collections data over the next few months will be challenging. One of the support measures announced by the government allows employers to defer PAYE as a cash flow relief measure but they will still ultimately be required to pay. Thus, it is unclear to what extent weak tax collections in the coming months (which are reported on a cash, as opposed to accruals, basis) might reflect deferrals of liabilities, as opposed to lower tax liabilities. However, Kieswetter also warned that the initial estimates of costs of R70bn for the COVID-19 tax relief measures would actually come in 'much higher', due to a higher number of applications for SARS's case-by-case assessment of tax deferral eligibility, as well as an expected decline in tax compliance

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by businesses struggling with cash flow problems. Overall, Kieswetter said that the tax shortfall (relative to the original 2020 Budget target) could amount to R285bn.

Expenditure will be higher than estimated in February

Additionally, new spending pressures seem likely to be much greater than we envisaged before the announcement of the government's R500bn economic support package. To be sure, not all of the package is an immediate above-the-line fiscal cost. For example, R200bn is a loan guarantee programme, which only shows up as a contingent liability, while R130bn will be financed from reprioritisation within the existing budgetary envelope. On 30 April, the National Treasury outlined to the parliament the estimated costs of the various elements of its COVID-19 economic support package and the associated financing (Figure 13). Still, about R95bn – nearly 2% of GDP – reflects new borrowing from multilateral institutions, while R60bn will be transferred from social security funds, which will not show up in the main budget balance but will reflect in a deteriorated consolidated deficit.

Figure 13: Sources and uses of the government's R500bn economic support package

Programmes	Cost (Rbn)	Financing	Amount (Rbn)
Corporate loan guarantee scheme	200	Contingent liability	200
Job creation and SME support	100	Reprioritisation	130
Corporate income support and cash flow relief*	70	Transfers from social security funds	60
Wage protection via UIF (TERS scheme)	40	Available funds in the Department of Social Security Budget	15
Expansion of social grants	50	Borrowing from multilateral institutions	95
Medical and other frontline spending	20		
Municipal transfers for water, etc.	20		
Total	500		500

Source: National Treasury, Absa Research

Prospects for a renegotiation of a pay deal with public sector workers are unclear, but the Treasury could still reset the CPI-related pay adjustment on a softer inflation outlook

When the government tables a revised 2020 Budget on 24 June, the expenditure numbers will be of particular interest. One thing that is currently unclear is the prospect for Finance Minister Mboweni's plan to reset the terms of the third year of the existing wage deal, to save R38bn on public sector pay. Unions initially said that they would fight these plans when Mboweni tabled the budget in February, but they have been rather silent recently, as the gravity of the COVID-19 situation has become more apparent. With the wage settlement formally indexed to the CPI, the softer inflationary outlook appears to offer some limited scope for savings. We forecast CPI inflation of just 2.6% in the current fiscal year, 1.8pp below what the National Treasury pencilled into the 2020 Budget in February, a deviation that would translate to about R11bn in savings. However, we believe this will probably just be folded into the R130bn budgetary reprioritisation.

It may be difficult for the government to rescind the increase in social grants

In April, we forecast that spending in excess of the initial budgetary allocation would amount to R50bn on the assumption that the government would not win the argument on public sector pay. Uncertainty about the government's plans is elevated, but we now assume that non-interest spending will be R95bn above the original 2020 Budget target. Investors should also pay close attention to what the government signals on non-interest spending in FY21/22. We have assumed that all of the COVID-19 support package will be rolled back, but in practice, the government may find it difficult to rescind a big portion of the R50bn extra social grant spending, when its planned duration finishes in October.

As debt jumps sharply, so will debt service costs

However, this is not the end of it, because, of course, the ballooning deficits also imply big increases in debt service costs. We do not know what growth, inflation and tax elasticity assumptions underpinned Kieswetter's estimate, and indeed, the commissioner himself would no doubt acknowledge a high degree of uncertainty about these key variables. However, taking his projection of a R285bn tax shortfall, along with the National Treasury's support package, and plugging these data directly into our fiscal model with our deteriorated growth expectation and softer inflation suggests a main budget deficit of around 16% of GDP in the current fiscal year, (Figure 14). This will send South Africa's debt leaping higher, pushing the country further into a debt trap, such that gross government debt is likely to rise to 84% of GDP at the end of this fiscal year and debt service is likely to consume 21 cents of every rand collected in tax (Figure 15). Of

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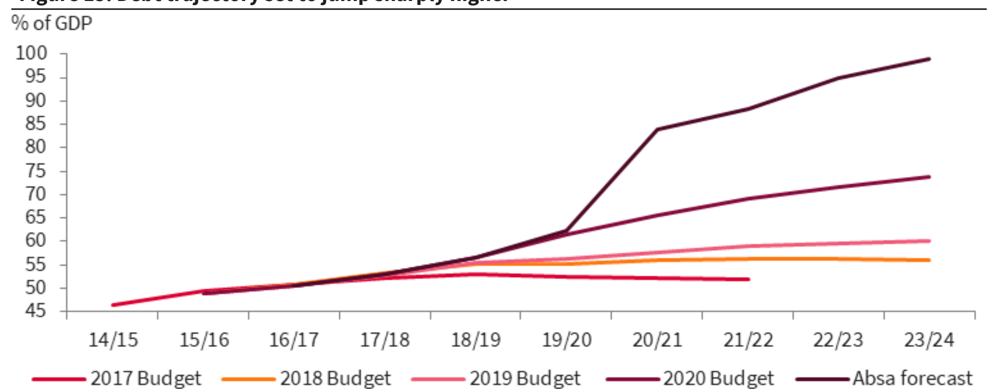
course, this is an exceptionally challenging year. However, the inexorable arithmetic of fiscal and debt dynamics means that even if some growth returns next year, South Africa will be deeper in the debt trap. Thus, even after a material adjustment effort over the next few years, without sharply higher growth, the debt ratio will still likely rise to nearly 100% of GDP by the end of FY23/24, with the costs of servicing it set to eat up a quarter of all taxes collected.

Figure 14: Absa Research expects a sharply deteriorated set of fiscal numbers when the National Treasury tables a revised 2020 Budget on 24 June

Rbn except as noted	2016/17	2017/18	2018/19	2019/20F	2020/21F	2021/22F	2022/23F	2023/24F
Macro context								
Real GDP, % y/y	0.8	1.6	0.4	-0.1	-11.0	5.6	1.2	1.4
GDP deflator, % y/y	6.2	4.8	4.3	3.7	3.9	4.8	5.0	5.3
Nominal GDP	4419	4699	4921	5098	4711	5212	5541	5920
% change	7.1	6.3	4.7	3.6	-7.6	10.6	6.3	6.8
Deviation from Budget target	0	0	0	-59	-718	-547	-585	NA
Revenues								
Tax elasticity	0.97	1.00	1.23	1.47	2.10	1.10	1.10	1.10
Tax hikes	0	0	0	0	0	20	20	20
Gross tax revenue	1144	1216	1288	1356	1139	1293	1403	1528
Main budget revenue	1138	1196	1275	1342	1112	1265	1374	1493
Deviation from Budget target				-3	-286	-219	-207	NA
Spending								
Non-interest spending, baseline increase at CPI	1159	1242	1325	1477	1537	1570	1636	1710
COVID-19 bailout spending financed by borrowing					95	0	0	0
Non-interest spending	1159	1242	1325	1477	1632	1570	1636	1710
Interest costs	146	163	182	205	243	293	342	386
Main budget expenditure	1305	1405	1507	1682	1874	1862	1977	2104
Deviation from Budget target				0	108	11	37	NA
Key fiscal metrics								
Deficit	-167	-209	-231	-341	-762	-597	-603	-611
as a % of GDP	-3.8	-4.4	-4.7	-6.7	-16.2	-11.5	-10.9	-10.3
Primary balance, % of GDP	-0.5	-1.0	-1.0	-2.7	-11.0	-5.8	-4.7	-3.8
Debt	2233	2490	2788	3176	3956	4603	5252	5863
as a % of GDP	50.5	53.0	56.7	62.3	84.0	88.3	94.8	99.0
Debt service as a % of tax revenues	12.8	13.4	14.1	15.1	21.3	22.7	24.4	25.3

Source: National Treasury, Absa Research

Figure 15: Debt trajectory set to jump sharply higher



Source: National Treasury, Absa Research

South Africa is heading into some rocky fiscal waters, which will require deft and radical new approaches

There is no easy solution. Taxes seem likely to rise, but the ability of the government to squeeze a lot more money out of a substantially poorer country is questionable. At some point, on the current trajectory of unsustainable debt trends, private investors could become reluctant to lend to the government without a sharply higher risk premia. A full IMF Standby Arrangement with potentially politically unpalatable conditionality could come to be the only alternative to more radical measures like SARB monetisation of the deficit or prescribed assets. Still, there is a long way to go before any more radical steps become inevitable. South Africa's experience under the imminent

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Rapid Financing Instrument loan of about USD4.2bn may pave the way for further IMF lending and adjustment assistance later on. Thus, the government's plan to table a revised 2020 Budget in June will be key not just in terms of its estimates of the fiscal damage from COVID-19 but also the government's longer-term plans for dealing with it.

We see scope for a least an additional 50bp worth of monetary policy easing

The SARB has responded strongly so far this year

The pace and depth of the economic crisis caused by the COVID-19 pandemic has no precedence in modern times. For policymakers around the world, the current approach is to provide as much support to the economy as possible to keep the economy on life support. The SARB has already responded strongly, cutting rates by a cumulative 275bp since the start of the year, including the 50bp cut delivered this week. The SARB has also intervened with a range of measures to ease liquidity constraints in the domestic financial markets, including its decision to purchase government bonds in the secondary market. By our calculations, the interest rate cuts put back a combined amount of nearly R100bn into the hands of consumers and firms over the course of a full year.

The 50bp cut this week was in line with our expectations, but the fact that two MPC members preferred a smaller cut surprised us

The SARB's decision to cut the repo rate by a further 50bp this week (after a 100bp cut at an emergency meeting in mid-April) was in line with our expectations and the consensus, but the fact that two MPC members preferred a smaller cut of 25bp surprised us and suggests that the MPC may be swinging behind a view that it has done enough – for now. However, we found the downward revision of the SARB's GDP forecast from -6.1% (at the emergency April model run) to -7.0% to be surprisingly small, given the lockdown extension and the mounting adverse anecdotal evidence. As we have elaborated, we see a bigger GDP contraction in 2020 of -9.7%. We also forecast smaller increases in 2021 and 2022 of 3.1% and 1.7%, respectively, compared with the SARB's growth forecasts of 3.8% and 2.9%, respectively.

Economic activity is likely to shrink sharply in 2020 and inflation will likely remain below 3% from Q2 20 through to Q1 21

Inflation is also exceptionally subdued. The magnitude of the contraction in economic activity is likely to decimate pricing power across parts of the economy where prices are competitively determined. We expect headline CPI inflation to ease to 3% y/y in April and then substantially breach this lower band of the target range to remain well below 3% into early-2021. This is in contrast to the SARB's latest inflation forecast, which sees only a marginal two-quarter target breach, which Governor Kganyago said the MPC would 'look through'. Since the SARB's QPM operates on real interest rates, a more benign inflation outcome will lead the QPM to price in more rate cuts, as would a GDP outcome in line with our new baseline forecast, since it would serve to increase the output gap.

We expect another 50bp cut in July in addition to the 50bp we expected the SARB to deliver at the May MPC meeting

Overall, we believe that international and domestic developments will manifest in a way that elicits still more monetary policy support from the SARB. Thus, we are pencilling in an additional 50bp of easing into our baseline forecast on top of the 50bp this week. Predicting the timing of such future cuts is difficult, but we believe – regardless of the stance of the two hawkish members of the MPC this week – that it could come as early as the scheduled July meeting, after the Q1 20 GDP release. Ultimately, the elevated uncertainty about the extent of the economic damage from COVID-19 and the lockdown restrictions suggest that the cost of providing too much support now is probably a lot smaller than the cost of providing too little. With South Africa still some distance away from the zero lower-bound on policy rates, the SARB has a lot of monetary policy space to respond from, if required.

Downside risks dominate with a long fat tail

A better outcome than our baseline is possible but quite a few things need to go right for this to happen

Forecasting is an inherently uncertain exercise, even in the most stable of times. Many different economic outcomes are possible, depending on future developments that are essentially unknowable. And now, in the midst of this unprecedented crisis, uncertainty is higher than ever. It is possible that South Africa could produce a GDP outcome that is better than our new baseline forecast (i.e., something more akin to our mid-April forecast of a GDP contraction of -6.4% in 2020) if some robust and fulsome combination of the following four things happen:

- South Africa's economic support policies prove effective at lifting the economy quickly out of the COVID-19 doldrums;

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- the South African economy adapts quickly to operate under social distancing imperatives;
- the global reverberations from COVID-19 prove light; and
- a treatment or vaccine is found fairly soon.

Even under this slightly rosier scenario, policy settings in the near to medium term are unlikely to deviate from our baseline forecast. After all, the fiscal support package is now in place, and as for monetary policy, the economy would still be objectively weak, in need of all the support that the MPC could throw at it. A slightly rosier outcome than our baseline forecast is, after all, still a pretty terrible outcome for South Africa.

A worse outcome than our baseline is a material possibility, and we think is a higher probability than a better outcome

On balance, we believe the risks to our baseline forecast are tilted in the direction of a worse outcome, because economic weakness tends to feed on itself. In a complex integrated global economy under significant stress, the number of things that can go wrong far outweighs the small number of ways that things can fit together to go right, and once things go wrong, they take a lot longer to fix than they took to fall apart. In particular, with the government's warning that peak infections will come in August/September, possibly necessitating a return to Stage 4 or Stage 5 lockdown restrictions, and hysteresis begins to throttle the economy hard, we could see an even steeper GDP contraction than our baseline forecast. We compiled a downside risk scenario to our baseline forecast by looking at the likely effect on different production sectors of a hypothetical (at this stage) extension of stringent lockdown measures well into Q3. This downside scenario generates a GDP contraction over 12% in 2020, with less than a quarter of this loss recouped in 2021. Under this scenario, GDP would be nearly 10% smaller in 2021 than it was in 2019. In other words, the country would be significantly poorer, more leveraged, and more unequal for longer.

A worse outcome would elicit more rate cuts from the SARB, wider budget deficits and a weaker currency

Of course, if the economy faltered to this degree, neither policymakers nor investors would stand on the sidelines. Under this scenario, the main budget deficit could reach over 19% of GDP and public indebtedness to 90% of GDP. Clearly, the government would have no room to expand the scale of its support package, this lack of fiscal space could conceivably tip policy towards more reform or towards more populism. Additionally, under this scenario, we would expect the rand to weaken (instead of strengthening) to 21 per USD by the end of Q3. This would push up imported prices, but demand overall would be weaker, leaving CPI inflation fairly subdued. Regardless, we do believe such an outcome would be accompanied by substantially more easing from the SARB of up to 150bp more on top of what we currently expect.

This is an unprecedented setback for South Africa

In conclusion, the next few months will prove critical for South Africa as it struggles to contain rising infection rates and prevent the economy from collapsing. The second quarter economic data are obviously going to be terrible. That much is certain. What is less certain – and more important – is how rapidly the economy bounces back after the lockdown restrictions are substantially relaxed. How many workers will be retrenched? How many firms will go bankrupt? How ably will the government and the private sector adapt to the new necessities of a post-pandemic world? All of these questions are of critical importance for South Africa's economic outlook. As events unfold, we will be able to refine and update our forecasts.

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Figure 16: In our baseline forecast, a big GDP contraction in 2020 will reflect commensurately in consumption and investment

	2019		2020				2021									
	Q3	Q4	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F	2018	2019	2020F	2021F	2022F	2023F
Output (% q/q saar)																
Real GDP	-0.8	-1.4	-1.1	-19.2	-10.0	-8.5	-6.4	14.3	3.6	3.0	0.8	0.2	-9.7	3.1	1.7	1.2
Real GDP (%y/y)	0.1	-0.6	-5.4	-53.9	52.6	5.1	3.6	2.8	2.8	2.8	0.8	0.2	-9.7	3.1	1.7	1.2
Private consumption	0.3	1.4	-2.3	-23.1	-4.1	4.4	3.2	3.5	3.9	4.6	1.8	1.0	-5.1	0.8	1.1	1.3
Public consumption	1.4	-0.2	-0.5	0.6	0.6	-0.5	-0.5	-0.5	-0.5	-0.5	1.9	1.5	0.3	-0.3	-0.5	-0.5
Investment	4.1	-10	-8.3	-63.4	-33.3	-7.0	8.2	9.3	9.7	10.5	-1.4	-0.9	-23.3	-8.0	2.0	1.9
Exports	3.5	2.3	-4.1	-54.8	26.6	5.1	5.2	5.9	6.8	6.8	2.6	-2.5	-11.0	2.3	1.8	1.9
Imports	-8.9	-8.5	-0.6	-63.8	45.9	4.7	6.1	6.6	6.5	6.9	3.3	-0.5	-14.4	2.7	2.4	1.2
Prices (% y/y)																
CPI inflation	4.1	3.7	4.4	2.5	2.4	2.6	2.8	4.2	4.3	4.3	4.6	4.1	3.0	3.9	4.1	4.5
Core CPI inflation	4.1	3.9	3.7	3.5	3.4	3.5	3.6	3.6	3.7	3.7	4.3	4.1	3.5	3.7	3.9	4.4
PPI inflation	4.5	2.9	4.2	0.9	1.1	1.8	2.3	4.1	4.4	4.4	5.5	4.6	2.0	3.8	4.2	4.4
External and government accounts (% of GDP)																
Current account	-3.7	-1.3	1.7	0.5	-1.3	-1.6	-2.0	-2.1	-2.1	-2.2	-3.6	-3.0	-0.2	-2.1	-2.8	-2.9
Main budget fiscal balance*	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	-4.7	-6.7	-16.2	-11.5	-10.9	-10.3
Main primary balance*	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	-1.0	-2.7	-11.0	-5.8	-4.7	-3.8
Government debt*	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	56.7	62.2	84.0	88.3	94.8	99.0
Interest rates and exchange rate (eop)																
Repo rate, %	6.50	6.50	5.25	3.75	3.25	3.25	3.25	3.25	3.50	3.50	6.75	6.50	3.25	3.50	4.25	4.75
Prime rate, %	10.00	10.00	8.75	7.25	6.75	6.75	6.75	6.75	7.00	7.00	10.25	10.00	6.75	7.00	7.75	8.25
ZAR per USD	15.17	13.98	17.84	18.00	17.00	16.40	16.56	16.73	16.89	17.06	14.35	13.98	16.40	17.06	17.71	18.60

**Note: fiscal year starting 1 April, e.g. 2019 = FY2019/20, Source: National Treasury, SARB, Stats SA, Thomson Reuters, Absa Research*

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- Lelanie Boulle