South Africa Q2 20 Quarterly Perspectives

Economic calamity of COVID-19

- **The COVID-19 pandemic creates a much harsher global backdrop for South Africa. A global recession is now likely in 2020, with only a slow recovery thereafter. With South Africa's big budget deficit, a world of sharply less capital inflows is a big blow.**
- **Surprisingly, South Africa so far seems to be doing relatively well vis-à-vis the virus itself, with no exponential growth in new infections. Nonetheless, the government has extended its strict three-week lockdown by two weeks to end-April. However, some parts of the economy such as mining might be allowed to go back to work a little earlier, while others might still be restricted even after the full lockdown is lifted.**
- **SA was already in recession when COVID-19 hit, but Q2 20 will mark a huge step-down in activity, with only a gradual and partial recovery afterwards, given likely permanent firm closures and worker layoffs. We forecast real GDP to contract by 6.4% in 2020, more than double our -3.1% forecast a few weeks ago before the lockdown extension, manifesting via consumer spending, business capex and exports. Downside risks to growth still dominate, as weakness begets more weakness.**
- **The unmatched economic contraction will ravage already fragile public finances. Critical spending needs that cannot be fully financed by reallocation from within the existing budget envelope will manifest, and tax revenues will crater. We expect a double-digit main budget deficit of 12.5% of GDP this year, and public debt is set to soar to 76.4% of GDP by the end of FY20/21. The Finance Minister has said that South Africa will look to secure some multilateral funding.**
- **Inflation will likely breach the target to the downside, despite the weaker exchange rate. Meanwhile, the current account will benefit in the near-term from a big terms-of-trade gain, but the capital account remains under pressure from portfolio disinvestment. The rand has weakened a lot already, but is likely to recover once the pandemic is under control; we see USDZAR at 16.40 by year-end. A further 50bp of rate cuts are likely.**
- **More credit rating downgrades likely loom, given Negative Outlooks from all three rating agencies. Once the crisis recedes, SA needs to lower its huge budget deficit and implement growth-boosting reforms to avoid further deterioration. The government says it will use this crisis to accelerate structural reforms but implementation remains a risk, although the government's adroit handling of the public health aspect of the pandemic could boost the popularity of President Ramaphosa and his team of reformers, giving them political capital to accelerate and broaden the structural reforms agenda**.

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Figure 1: Sharply weaker growth trajectory, downside inflation breach, and yawning fiscal deficits

	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	-5.4	-36.5	26.8	6.4	3.2	2.6	2.0	1.6	0.8	0.2	-6.4	2.8	1.6	1.2
Real GDP (%y/y)	0.1	-0.6	-1.1	-12.4	-6.9	-5.1	-3.0	9.3	3.5	2.3	0.8	0.2	-6.4	2.8	1.6	1.2
Private consumption	0.3	1.4	-2.3	-13.3	-2.1	4.1	2.6	2.8	3.2	3.5	1.8	1.0	-2.8	1.4	1.1	1.3
Public consumption	1.4	-0.2	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	1.9	1.5	0.0	-0.5	-0.5	-0.5
Investment	4.1	-10.0	-8.3	-53.0	-28.8	-4.5	7.2	8.0	8.7	9.0	-1.4	-0.9	-19.2	-5.5	1.5	1.6
Exports	3.5	2.3	-4.1	-48.9	15.8	12.9	5.2	5.9	6.8	6.8	2.6	-2.5	-9.6	3.4	2.7	2.7
Imports	-8.9	-8.5	-0.6	-1.4	-1.7	0.8	1.9	2.3	2.8	2.9	3.3	-0.5	-2.3	1.3	1.0	1.2
Prices (% y/y)																
CPI inflation	4.1	3.7	4.4	2.6	2.7	2.8	3.0	4.3	4.3	4.3	4.6	4.1	3.1	4.0	4.5	4.7
Core CPI inflation	4.1	3.9	3.7	3.4	3.4	3.5	3.6	3.6	3.7	3.7	4.3	4.1	3.5	3.7	4.0	4.1
PPI inflation	4.5	2.9	4.2	1.4	1.9	2.6	3.1	4.4	4.4	4.4	5.5	4.6	2.5	4.1	4.2	4.4
External and government accounts (% of GDP)																
Current account	-3.7	-1.3	-1.1	-1.5	-1.8	-1.9	-2.2	-2.4	-2.4	-2.4	-3.6	-3.0	-1.6	-2.4	-2.7	-3.2
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	-12.5	-9.4	-8.3	-7.2
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	-7.8	-4.3	-2.8	-1.5
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	76.4	79.8	83.6	85.1
Interest rates and exchange rate (eop)																
Repo rate, %	6.50	6.50	5.25	3.75	3.75	3.75	3.75	3.75	4.00	4.00	6.75	6.50	3.75	4.00	4.25	4.25
Prime rate, %	10.00	10.00	8.75	7.25	7.25	7.25	7.25	7.25	7.50	7.50	10.25	10.00	7.25	7.50	7.75	7.75
ZAR per USD	15.17	13.98	17.84	18.00	17.00	16.40	16.20	16.40	16.61	16.82	14.35	13.98	16.40	16.82	17.67	18.57

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

COVID-19 is an unprecedented global shock

The COVID-19 pandemic is tipping the global economy into an unprecedented recession

The COVID-19 pandemic is cutting a swathe of devastation through the global economy, with the IMF and the OECD now forecasting an unprecedented global recession. The International Monetary Fund's latest forecasts published earlier this week point to a global contraction of 3.0% this year, comprised of -6.1% for advanced economies and -1.0% for emerging and developing economies. Similarly, the Institute of International Finance has forecast a 2.8% global contraction. By way of comparison, the IMF estimates that global GDP fell 0.1% in the global financial crisis (GFC) in 2009. Meanwhile, the OECD has estimated that the 'initial' impact of the lockdowns for its member countries could range between a fifth and a third of their output, and that each month of strict containment measures would cut GDP growth by 2ppt. The World Trade Organisation forecasts that global trade volumes will contract between 13% and 32% this year, compared to 12.5% during the GFC.

A sharply weaker global economy has big negative consequences for South Africa

This global context of severely weakened global activity, collapsed commodity prices (aside from gold) and heightened risk aversion will greatly challenge South Africa, even before accounting for the domestic costs of fighting the disease. South Africa, as a small open economy, remains highly reliant on ongoing inflows of foreign capital to fund its twin deficits. Fortunately, many countries across the globe have responded vigorously to the pandemic, offering sizeable fiscal and monetary medicine to keep their economies on life support while they battle to bring the pandemic under control. However, it is too early to say with confidence when the social distancing measures, with their attendant economic costs, can be safely relaxed. Nor is it clear how quickly or fully the economic medicine can restore the global economy to relatively robust health. We believe that the global recovery will be slow and partial. Some important features of the global economy prior to the crisis – including but not limited to mass international tourism, wide-ranging globalised supply chains, public finances to name a few examples out of many – will likely be permanently changed.

South Africa, while battling its own manifestation of the COVID-19 shock will also have to navigate a different world.

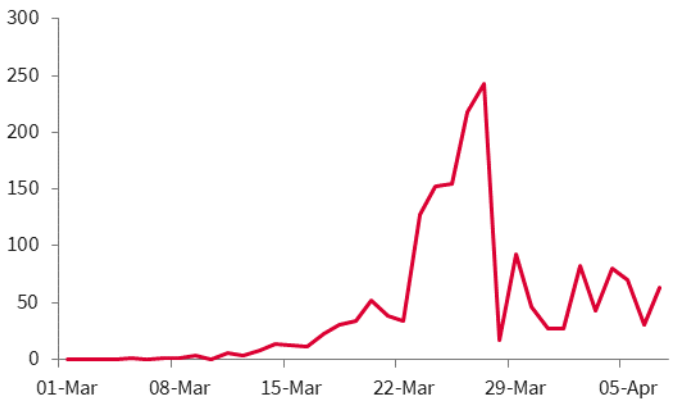
Positively, South Africa adopted aggressive measures to battle COVID-19 early while widespread vaccination against tuberculosis may also to prove to be a plus. Negatively, large parts of the population are relatively impoverished, living in close proximity, and many HIV+ people are not receiving ARV treatment

The good news is that South Africa introduced strict social distancing measures and contact tracing seemingly relatively quickly. Additionally, recent scientific evidence suggests that near-universal childhood inoculation against tuberculosis may be serving to lessen the incidence and overall mortality rate of the disease. South Africa's relatively young population may also help, with StatSA's data showing that nearly 72% of the population is under 40 years old while only 9% is above the age of 60. However, South Africa's extreme income inequality means there are large segments of the population living in relative poverty and in close proximity to each other in townships and informal settlements, often with scant access to good hygiene and quality health care. Additionally, the high rates of HIV and tuberculosis in South Africa are potential co-morbidity factors, even for relatively young people, with only a little over half of South Africa's HIV+ population of nearly 8mn people currently receiving anti-retroviral treatment. Overall, it is still much too early to know how the pandemic will develop.

New infection rates have been surprisingly subdued but it is hard to know how much of this is due to the early adoption of very draconian social distancing measures versus other more sustainable factors

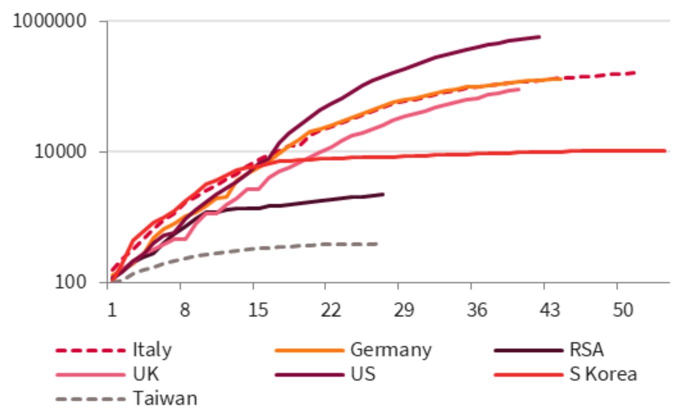
Still, the available data seem to suggest that South Africa's incidence curve may be flatter than for many other countries, although insufficient testing to date warrants caution about this conclusion, especially since COVID-19 cases have been confirmed in at least two of South Africa's townships, and a significant proportion of people who contract COVID-19 may be asymptomatic. However, the latest data show no big escalation of new COVID-19 cases in recent days (Figure 1) and the incidence curve compared to other countries looks relatively good. Nonetheless, the risk that South Africa's apparent early success against COVID-19 could collapse when social distancing is lifted explains why the government announced a two-week extension of the lockdown beyond its original termination date of 16 April, despite its big economic and social costs.

Figure 2: Confirmed daily new inflections are quite subdued



Source: Department of Health, Absa Research

Figure 3: South Africa's incidence curve appears relatively flat



Note: This logarithmic chart plots the number of cumulative COVID-19 infections (y-axis) against the number of days since the country hit 100 confirmed cases.
Source: John Hopkins University, Absa Research

A deep recession is inevitable

Forecasting models based on historical economic relationships are likely to struggle to reflect the impact of this unprecedented economic shock

As we highlighted in our recent report (*South Africa: From recession to full COVID lockdown*, 24 March), forecasting the magnitude of this unprecedented health shock is exceptionally challenging, not least because it has mutated into a complicated tangle of a demand shock, a supply shock, and a financial shock. It is hard to conceive of a model that would accurately reflect the interplay between these factors, running from micro to macro and from local to international and back again. In our 24 March report, we examined the various production-side components of GDP and tried to quantify the plausible impact of the lockdown on activity for each, assuming that the formal strict lockdown would be lifted on 16 April, and the pandemic would be largely brought under control by the end of Q2, so that economic activity could begin to recover in Q3. Our findings then were that South Africa's real GDP would contract by a record 3.1% in 2020, with mining and manufacturing, much of whose work cannot be done remotely, and activities related to tourism, such as aviation and hotels and catering, likely to take a particularly large and lasting hit.

The economic outlook has deteriorated in the last few weeks since we forecast a GDP contraction of 3.1%, especially with the lockdown extension

In the few weeks since we published that report, there has been little further quantitative data, while the qualitative and anecdotal evidence, both local and international, has pointed to a deteriorated outlook. And now, of course, the economy must endure a further two weeks in the deep freeze. Admittedly, President Ramaphosa suggested that some parts of the economy might be allowed to return to work earlier. For example, there have been extensive discussions in the mining industry about this. Full details of the government's plans in this regard are not yet available. However, it also seems likely that those parts of the economy that entail the movement and gathering of people will continue to be restricted even after the formal lockdown is lifted. In other words, the lockdown will likely be relaxed only gradually.

The lockdown will spark negative feedback loops in the highly leveraged and interdependent components of the economy

Moreover, we believe the hit to growth from the lockdown will not scale linearly into its length or intensity, because it will generate negative repercussions with multiplier effects, as economic weakness feeds on itself. Indeed, the negative economic consequences of COVID-19 will continue to manifest long after the virus is brought under control. Thus, after the lockdown-related growth seizure in Q2, while some bounce in real GDP is likely in Q3 (assuming the virus is under control by then), there will likely be much permanent damage to the productive capacity of the economy in the form of firm closures, worker layoffs, impaired balance sheets, shattered confidence and so on.

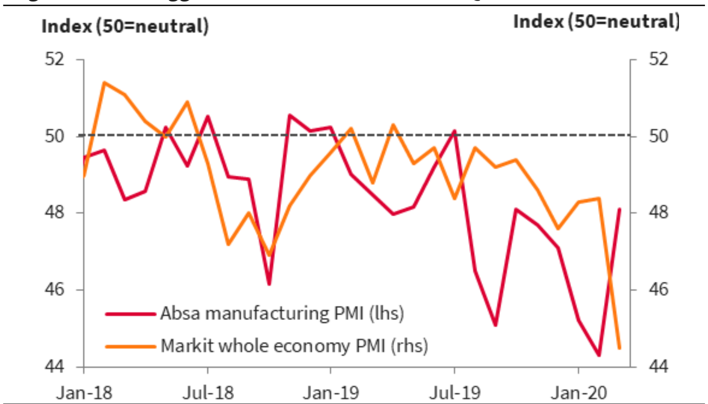
We now forecast a GDP contraction of 6.4%, with exceptionally heightened uncertainty but dominant downside risks

We now forecast that GDP will contract by 6.4% in 2020, but we caution that this forecast, like all others right now, has more than the usual degree of uncertainty and downside risk. Our forecast, however, is very close to the SARB's forecast published earlier this week that GDP would contract 6.1% this year (see *South Africa: Emergency MPC meeting delivers another 100bp cut*, 14 April, for more details) and the IMF's projection of a 5.8% contraction. Below we provide more detail on the quarterly trajectory and composition of our negative growth forecast from the demand-side of the national accounts. For a qualitative analysis of how different supply-side production sectors might fare in relative terms, we refer our readers to our 24 March report, even if the numbers have worsened since then.

Economy was already in recession in H2 19, and likely continued to contract into Q1 20

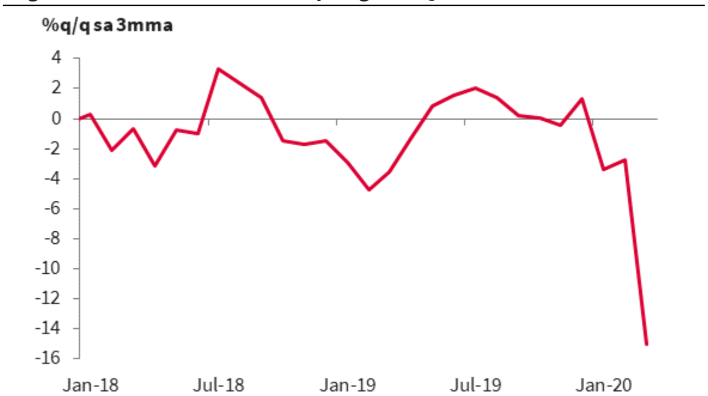
In terms of the outlook for 2020, it is important to remember that South Africa's economy was already not doing well, even before the COVID-19 pandemic percolated into general awareness and elicited a strong containment response from the government from mid-March onwards. In H2 19, South Africa slipped into its second recession in as many years. There is little hard activity data available yet for the Q1 20, although the high frequency monthly data for mining and manufacturing output and retail sales in January were good. Still, we believe South Africa is likely to have continued its run of negative GDP growth prints in the first quarter, as more intense load shedding, in line with Eskom's new stricter maintenance approach, began to bite from the end of January till mid-March when social distancing measures began to take hold. National accounts data for Q1 20 will only be published at the beginning of June. In the meantime, high frequency indicators from StatsSA may be delayed. However, South Africa's two PMIs in Q1 suggest intensifying weakness, with the bounce in the Absa manufacturing sector PMI in March due entirely to supply chain disruptions causing a big jump in supplier lead times, rather than delays due to firms operating at full capacity (Figure 4). Meanwhile, NAAMSA data on new vehicle sales up to end March also point to a steep contraction in household spending on consumer durables (Figure 5). Overall, we forecast a GDP contraction of 5.4% q/q saar in Q1 20.

Figure 4: PMIs suggest intensified contraction in Q1 20



Source: BER, Markit, Absa Research

Figure 5: New vehicle sales have plunged in Q1



Source: NAAMSA, Absa Research

Different parts of the economy will be affected by the lockdown to different degrees

In Q2 20, large parts of the economy were put into the deep freeze with the lockdown. On the assumption that the lockdown would only last a little over two weeks into Q2 20, our report in late March estimated a 23.5% q/q saar contraction in Q2 20, equivalent to a level (non-annualised) drop of 6.5% from Q1. Coal mining and food manufacturing, each accounting for about a quarter of total mining (7.2% of GDP directly) and manufacturing (12.2%), respectively, were not shuttered, while select other parts of these individual production sectors were also allowed to continue, albeit at reduced levels. For example, in the manufacturing sector, production of basic products in addition to foodstuffs will continue and it is interesting to see various news stories about companies seeking to reorient to produce facemasks and domestic ventilators. Of course, some parts of South Africa's secondary industries will come to a dead halt during the lockdown, for example, construction, which accounted for 3.3% of 2019 GDP.

Eskom says that electricity demand has fallen by a quarter during the lockdown, and most of this decline will have come from energy intensive industries

Eskom gave evidence of the slowdown in Q2 at the beginning of April when it said that electricity demand had dropped by 7,500MW to 9,500MW during the lockdown, roughly a quarter of its normal level. With South Africa's residents remaining at home, this reduced demand will have come entirely from the shuttering of commercial enterprises, and particularly energy intensive mining and manufacturing activities.

Much of services sector work can be done remotely, but there may not be any demand for the products if the underlying economy bottoms out

In the tertiary sector, the output of government (15.5% of GDP in 2019) will register no big decline, in part because its output is measured by proxy as the cost of the inputs, i.e., wages of civil servants even if some of them, such as teachers, are not actually working during the lockdown. Elsewhere in the tertiary sector, the contribution of finance, insurance, and real estate (FIRE) to GDP, which stood at 21% of GDP in 2019, may be relatively unscathed during the lockdown, since much of the work can be done remotely, although the need for financial intermediation of any kind will drop as the underlying economy slows. New real estate transactions will likely drop to zero, although rental payments will continue, but it is unclear how rental holidays will be accounted for in the national accounts, even if one could have a read on how widespread they are generally. Communication (2.7% of GDP) will likely prove quite immune to the pandemic, while for hotels and catering (0.7% of GDP) it is a mortal blow, and many personal services (5.7% of GDP) that require face-to-face contact will also shudder to a dead stop.

The lockdown extension will deepen the Q2 contraction; we now forecast a level drop of over 10%, equivalent to –36.5% q/q saar

Regardless of these specific sectoral considerations, the extension of the lockdown will deepen the Q2 contraction from what we envisaged previously. We now forecast it to fall 36.5% q/q saar in Q2, equivalent to a level drop of over 10%, on the assumption that South Africa's lockdown will begin to ease at the end of April. The risks seem tilted in the direction of stringent social distancing measures beyond April and hence for a deeper Q2 GDP contraction. Still, assuming that both the local and global authorities will largely be on top of COVID-19 by the end of Q2, it seems likely that there will be some recovery, albeit a weak one, in the second half of the year.

Econometric estimates based on historical relationships will struggle with this unprecedented shock

How will this baseline scenario be manifested in the demand side of the national accounts? We point out that the econometric equations built into our demand-side model are based on historical relationships, and even if we could be certain about the explanatory variables, such as household income, which is the primary driver of consumption, or business confidence, which is key to private fixed investment spending, the shock is unprecedented. Thus, historical relationships are unlikely to be a very reliable guide for how things will play out this time. Still, we ran Absa's demand-side macroeconomic model with key input assumptions that are consistent with the current COVID-19 scenario, and with heavy judgement to reflect the unprecedented nature of the shock.

Forecast assumptions are key

Given such a difficult forecasting exercise, it is important to be clear about the key input assumptions. The most important ones, which have changed substantially from our last forecasting round in January, are the following:

- A weaker exchange rate, with USDZAR hitting 18.00 by mid-year, and recovering to 16.40 by end-2020, as opposed to 16.13 in our last baseline forecast that we ran in January;
- A G7 recession of 4.0% in 2020, compared to growth of 1.5% in our last baseline forecast, and Chinese growth of 1.1% in 2020, compared to 5.8% in our last baseline forecast;

- A weaker oil price, with Brent averaging USD34/bbl in 2020 compared to USD60/bbl previously; and
- A total 275bp of monetary easing this year (with 225 already in place) versus just 25bp in our January forecast.

Much of the GDP contraction will manifest via lower household consumption

We believe that much of the contraction in GDP in Q2 will manifest in the demand side of the national accounts via declines in household consumption spending, since non-essential retail has ground to a near halt. Of course, supermarkets and pharmacies are staying open during the lockdown, and StatsSA reports that in 2019, the sales of general dealers (which includes supermarkets), specialty food and beverage stores, and pharmacies accounted for 57% of total retail sales, which are about a third of total household consumption. In general, discretionary household spending on durables (especially autos) and semi-durables is likely to take more of the hit in Q2, while spending on nondurables and services tends to be more essential, and, in the case of services, contractual (Figure 6). We tentatively project a contraction of 13.3% q/q saar in household consumption spending in Q2. Some recovery is likely after the lockdown lifts, but there will almost certainly be some long-lasting damage to household incomes, balance sheets and confidence that will weigh on the strength of the recovery. We forecast household consumption to contract 2.8% overall in 2020.

Figure 6: Durables and semi-durables will bear the brunt of the hit to overall household spending

	% share in total consumption	Assumed % q/q saar				Real GDP 2020F, % y/y
	2019	Q1 20	Q2 20	Q3 20	Q4 20	
By broad category						
Durables	9.9	-6.9	-58.8	-34.3	10.5	-18.7
Semi-durables	9.6	-5.6	-26.5	-6.8	7.5	-6.3
Non-durables	36.8	-0.8	-3.8	2.2	3.1	-0.2
Services	43.7	-1.6	-5.2	2.2	3.3	-0.5
Total	**100.0**	**-2.3**	**-13.3**	**-2.1**	**4.1**	**-2.8**

Source: Statistics South Africa, Absa Research

The size of the consumption contraction depends materially on the scale of layoffs due to COVID-19, but pay trends matter too

We remind that the baseline forecasts presented here assume that although there will be some layoffs, most workers in mines and factories will retain their jobs, albeit perhaps with reduced shifts and reduced pay for a while. Meanwhile, many workers in some service industries will be able to either work from home for a while, or adjust working patterns. However, firms that go bankrupt will, by definition, shed labour. In the tourism sector, the majority of the 681k workers employed before COVID-19 will likely face layoffs, and many of the nearly 3mn workers in the informal sector could struggle to keep their 'jobs' if household incomes elsewhere, particularly among the poor, slump. In the 2009 GFC, about 500k workers lost their jobs from the peak to trough of private sector employment. However, this came after a longer period of robust growth during which firms added workers to their payrolls. In contrast, this time around, firms have been wringing excess workers from their payrolls over the past half-decade. Given the political and moral pressure on employers to retain their workforce during this crisis, we believe that at least some of the adjustment will come via pay restraint.

The uncertain outlook for fixed investment spending is also key for the GDP outlook

In other parts of the national accounts, we believe that much of the fixed investment spending will be put on hold, as business confidence falls further, heightened uncertainty prevails and some businesses fold. We expect a drop of 19.2% in fixed investment spending in 2020, followed by a further 5.5% contraction in 2021. By way of contrast, during the GFC, fixed investment spending shrank 6.7% in 2009 and then 3.9% the year after. We believe that private fixed investment spending will be particularly hard hit, but strained public sector balance sheets will also impinge, with the government in particular possibly needing to delay its capex as budgets are reallocated to fight COVID-19. As regards to net exports, it is hard to know where the balance of declining exports and declining imports nets out for GDP.. Meanwhile, government consumption is ought to remain relatively robust, while inventory run-downs will likely also feature for a while, in some sectors at least.

We forecast GDP will expand 2.8% in 2021, but this represents a weak base effect bounce rather than a strong recovery

The growth outlook from 2021 onwards is particularly shrouded, given the uncertain foundation of 2020. Provided our expectations of a gradual recovery in H2 20 are validated, a further creeping recovery seems likely in 2021. However, it is hard to see its magnitude and complexion. COVID-19 will fundamentally reshape the world and at this early stage of the pandemic, it is difficult to comprehend what that will look like. Still, we believe that after a 6.4% contraction in 2020, it would not be unreasonable to expect 2.8% growth the following year. However, our growth projections beyond 2020 imply that it could take several years for the absolute level of economic activity to return to pre-2020 heights. Finance Minister Mboweni's recent media statement that there would be a 'rapid upswing' in growth after 2020 seems perhaps more hopeful than probable. But of course uncertainty here is exceptionally high.

COVID-19 is a terrible blow to South Africa's weak fiscus and debt dynamics

The National Treasury's target of a main budget deficit of 6.8% of GDP in FY20/21 is now completely out of reach

Without doubt, the COVID-19 pandemic will put South Africa's already shaky public finances under the most severe pressure. The FY20/21 Budget unveiled by Finance Minister Mboweni at the end of February aimed for a main budget deficit for the current fiscal year of 6.8% of GDP. It was founded on an assumption of real GDP growth of 0.9%, GDP inflation of 4.4%, a tax elasticity assumption of nearly 1, and an expectation that R37.8bn (or 5.6%) could be cut from the public sector wage bill, along with substantial reallocation of spending priorities to free up resources, in part to bail out Eskom. Overall, the FY20/21 Budget looked for main budget expenditure growth of 5.0% this year over FY19/20, and revenue growth of 4.0% to produce a tax take of 25.8% of GDP. Both the revenue and expenditure projections now look completely out of reach.

Tax receipts will crater as nominal GDP growth collapses

One big hit will come from the impact of lower growth on tax receipts. Our forecast of real GDP growth of -6.9% this fiscal year, combined with GDP inflation of 5.2%, produces a nominal GDP forecast for FY20/21 of R5003bn – a tax base that is R425bn or over 8% smaller than the National Treasury forecast in February. Even assuming that the National Treasury could still collect 25.8% of GDP in tax as it envisaged in February, this still implies gross tax collections nearly R134bn lower than the 2020 Budget forecast.

Tax collections were surprisingly good towards the end of FY19/20, given the weakness of the economy

However, the tax elasticity assumption is critical. At the time of the 20/21 Budget, we argued that the efforts of the South African Revenue Service to reboot itself would improve collection efficiencies over time, and that it was not implausible to expect an improvement in tax elasticity as corruption and inefficiency were being slowly addressed. Recent tax collection data seem to support the idea that some improvement efficiencies were kicking in. In FY19/20, tax collections came in almost as the National Treasury had envisaged in the 20/21 Budget, even though the economy likely continued in recession in the first quarter to a degree that was likely not anticipated by the National Treasury.

History suggests tax elasticity is correlated with real activity levels

With such a large likely hit to real economic activity in FY20/21, the ability of South African Revenue Service to pull tax out of the economy seems likely to suffer well beyond the mere reduction of the underlying tax base, as measured by nominal GDP. Tax elasticity, for example, dropped sharply during the GFC, as workers lost jobs and bonuses, capital gains shrank, consumers rolled back optional purchases, and firm profitability nosedived. Tax buoyancy (which incorporates the effects of tax policy changes) dropped to just 0.83 in FY08/09 and then turned negative (-0.71) in FY09/10, when tax receipts dropped R26.4bn in nominal terms, about 1% of GDP at the time. Admittedly, part of this was due to R4.6bn tax breaks offered by the government in that fiscal year, but even excluding these, overall tax revenues fell in nominal terms, even though nominal GDP grew slightly.

Figure 7: Budget outcomes for FY20/21 look likely to be substantially worse than what the National Treasury forecast in February

National Treasury 2019 MTBPS	FY16/17	FY17/18	FY18/19	FY19/20F	FY20/21F	FY21/22F	FY22/23F
Real GDP, % y/y	0.8	1.3	0.6	0.6	0.9	1.4	1.7
GDP deflator, % y/y	6.3	5.0	4.1	4.2	4.3	4.6	4.6
Nominal GDP, Rbn	4419	4699	4921	5157	5428	5759	6126
% change	7.1	6.3	4.7	4.8	5.3	6.1	6.4
Tax elasticity	0.97	1.00	1.23	1.15	0.93	1.00	1.01
Gross tax revenue, Rbn	1144	1216	1288	1359	1425	1512	1610
% change	6.9	6.3	5.9	5.5	4.9	6.1	6.4
Total main Budget revenue, Rbn	1138	1196	1275	1345	1398	1484	1581
Expenditure, Rbn	1305	1405	1507	1682	1766	1851	1940
incl. public sector wage cuts, Rbn					-38	-55	-68
Interest costs, Rbn	146	163	182	205	229	258	290
Main Budget deficit, Rbn	-167	-209	-231	-338	-368	-366	-359
Main Budget balance, % of GDP	-3.8	-4.4	-4.7	-6.5	-6.8	-6.4	-5.9
Primary balance, % of GDP	-0.5	-1.0	-1.0	-2.6	-2.6	-1.9	-1.1
Gross debt, Rbn	2233	2490	2788	3176	3562	3978	4384
Gross debt, % of GDP	50.5	53.0	56.7	61.6	65.6	69.1	71.6
Absa Research forecast Q1 20	**FY16/17**	**FY17/18**	**FY18/19**	**FY19/20F**	**FY20/21F**	**FY21/22F**	**FY22/23F**
Real GDP, % y/y	0.8	1.6	0.4	-0.1	-6.9	4.2	1.5
GDP deflator, % y/y	6.2	4.8	4.3	3.9	5.2	5.5	5.5
Nominal GDP, Rbn	4419	4699	4921	5108	5003	5500	5890
% change	7.1	6.3	4.7	3.8	-2.1	9.9	7.1
Deviation from Budget target, Rbn	0	0	0	-49	-425	-259	-237
Tax elasticity	0.97	1.00	1.23	1.40	5.00	1.20	1.10
Tax hikes to be introduced in 2021 Budget, Rbn	0	0	0	0	0	20	20
Gross tax revenue, Rbn	1144	1216	1288	1356	1216	1381	1509
Main Budget revenue, Rbn	1138	1196	1275	1342	1189	1353	1480
Deviation from Budget target, Rbn				-3	-209	-131	-101
Spending adjustments, Rbn					50	21	30
Main Budget expenditure, Rbn	1305	1405	1507	1682	1816	1872	1970
Interest costs, Rbn	146	163	182	205	238	281	323
Deficit, Rbn	-167	-209	-231	-341	-627	-518	-490
as % of GDP	-3.8	-4.4	-4.7	-6.7	-12.5	-9.4	-8.3
Primary balance, % of GDP	-0.5	-1.0	-1.0	-2.7	-7.8	-4.3	-2.8
Debt, Rbn	2233	2490	2788	3176	3821	4389	4925
as % of GDP	50.5	53.0	56.7	62.2	76.4	79.8	83.6

Note: Readers may be surprised at the large positive elasticity in the table for FY20/21, but this is purely a function of the way tax elasticity is calculated. When nominal GDP growth approaches zero, as it does in our forecast, the elasticity will surge towards infinity, because the percentage change in nominal GDP is the denominator. Furthermore, when nominal GDP growth is negative and tax collections also fall in nominal terms, the elasticity will be positive.
Source: National Treasury, Absa Research

Corporate income tax receipts particularly vulnerable to the hit from COVID-19

We believe an even more dramatic outcome is likely this time. Such a sudden sharp drop in activity will hit all three of the main tax categories, but especially corporate income tax and dividend withholding tax, which, in the last fiscal year accounted for 18% of all tax collected in South Africa. In thinking about the prospects for tax collections in the year to come, investors should pay particular attention to the performance of the financial sector, as this has historically accounted for a large share of personal and corporate income tax collections (44% of PAYE PIT and 40% of CIT, respectively, according to the latest Tax Statistics publication). As the shock to activity will be much more brutal this time around than during the GFC, we have pencilled in a R140bn drop in tax collections, worth about 2.8% of GDP, and the risks appear tilted in the direction of an even bigger drop in tax collections. The R15bn in support measures announced by the National Treasury, largely through tax breaks (Figure 20) will also negatively affect total tax collections; although at just 0.3% of GDP, this impact is going to be dwarfed by the other negative hits. The planned auction of broadband spectrum, which the government seems confident will still take place before the end of the year, might conceivably be a small positive for government finances.

Figure 8: Lack of fiscal space has compromised South Africa's ability to provide substantial public spending support

Policy actions	Comments	Impact
Fiscal		
Tax subsidy of R500 per month for 4 months	This will be made specifically for private sector employees earning less than R6,500 and would be delivered under the Employment Tax Incentive.	R10bn
Delay of PAYE and provisional corporate tax liabilities	Businesses that are tax compliant and have turnover of less than R50mn will be allowed to delay 20% of their PAYE liabilities and a portion of their provisional corporate income tax payment in the next four months without penalty. SARS will accelerate payment of employment tax incentive from twice a year to monthly.	R5bn
Use of UIF reserves to support workers in SMEs and other vulnerable firms	The government has announced that it will use reserves in the UIF to extend support to small and medium sized firms as well as other vulnerable firms.	R30bn
Other policies		
Debt Relief Fund and Business Resilience Facility for SMMEs	Announced by the Department of Small Business Development, the Debt Relief Fund is aimed at providing some assistance to debt repayments, while the Business Resilience Facility is to assist specifically SMMEs that manufacture goods in demand where COVID-19 may have created shortages.	R500mn
An industrial funding package	The Industrial Development Corporation and the Department of Trade and industry will use this funding to assist vulnerable firms and to fast-track financing for firms that may be critical to fighting the virus.	R3bn (R130mn approved and R400mn expected to be approved)
A fund to assist SMEs in the tourism and hospitality sector	The Department of Tourism is making R200mn available to assist SMEs in the tourism and hospitality sector who will be hard hit by the new travel restrictions.	R200mn
Relief for smallholder farmers	The President announced on 9 April relief funds for smallholder farmers.	R1.2bn
Solidary Fund	This was set up to mobilise resources from private companies and organisations	R2.2bn raised (R1bn allocated)
Suspension of UIF contributions	The Department of Labour announced that distressed companies would be allowed a period of reprieve from making UIF contributions. Employees of companies closed for a brief period will be allowed to utilise the short-term UIF benefit typically reserved for workers who take extended sick leave.	n/a
Use of Temporary Employer/Employee Relief scheme to avoid layoffs	The scheme suspends the employment relationship between employers and employees for a period of up to six months, during which workers undergo training and receive 75% of their wages from the scheme.	n/a
Use of Compensation Fund for ill workers	Workers who fall ill through exposure at their workplace will be paid through the Compensation Fund.	n/a

Source: National Treasury, South African Government, Absa Research

Unions will not likely concede on this year's pay award, which suggests the budgeted expenditure envelope for FY20/21 will be breached

On the expenditure side of the budget, there are also big execution risks. As we noted above, the 2020 Budget was partly founded on an expectation that R37.8bn would be shaved from the public sector wage bill. We believe that this is unlikely to materialise, because to date, the public sector unions have categorically rejected any renegotiation whatsoever of the third year of the wage deal that was agreed in 2018. Unions have said they plan to fight the government in the bargaining council and in the courts over its failure to implement the agreement on 1 April.

Higher interest costs on the public debt and unavoidable COVID-19-related spending needs will be hard to finance out of the existing budget envelope

We also believe there will be unavoidable pressure for additional spending, either directly on healthcare or indirectly on economic support measures to re-float the economy, once COVID-19 is brought under control. Additionally, servicing the escalated public debt will weigh on the expenditure side of the budget. We are not optimistic about the National Treasury's assertion that it will fund these spending pressures entirely by reallocation of existing budget allocations, and so, we have pencilled in R50bn additional spending on top of the 2020 Budget envelope. Of course, if the government is able to secure some pay restraint then this would be helpful, but additional existential spending needs are an upside risk to the R50bn.

We expect a double-digit budget deficit this year of 12.1% of GDP

Overall, our projections suggest that the main budget deficit will hit double digits: 12.5% of GDP in the current fiscal year. The National Treasury has suggested that further tax increases are unavoidable, and we have pencilled in R20bn in the next fiscal year and again in FY22/23, which combined with some expected recovery in growth and in tax collection efficiency, should enable the budget deficit to resume a downward trajectory, but deficits are likely to remain startlingly wide. Of course, sharply wider budget deficits are likely to feature globally, but South Africa started into this pandemic from a weak fiscal position, with very slippery debt dynamics.

Debt to GDP likely to hit 75% of GDP by end of the current fiscal year, and further increases afterwards seem inevitable

In particular, given that the real interest rate on South Africa's public debt sharply exceeds the real growth rate of the economy, South Africa needs to be running a sizeable primary budget surplus to stabilise debt-to-GDP. However, with interest payments at c4.4% of GDP this year, South Africa will likely post a primary budget deficit of around 7.8% of GDP. Thus, absent any recourse to sizeable non-debt sources of financing, South Africa's debt burden looks set to mount sharply. We believe gross public indebtedness could hit over 76% of GDP by the end of the current fiscal year, up from 62% at the end of March, and further increases thereafter seem inevitable.

The willingness of private investors to lend further into rising indebtedness might be tested

It is unclear at what point on this relentless upward trajectory private investors become unwilling to finance South Africa further. Already the debt dynamics should give investors some cause for concern. Of course, South Africa can approach other lenders as well. It already has a New Development Bank loan for USD1bn, about 0.3% of GDP at the current exchange rate, for directly fighting COVID-19, while a further USD1bn might be made available later to finance the economic reboot effort.

An approach to the IMF is one option but it will be contested within the governing alliance and, regardless, the amount of funding available seems still short of South Africa's needs

Meanwhile, the IMF has said that it stands ready to deploy its USD1tn lending capacity into the crisis, but has estimated that countries' needs could amount to USD2.5tn. It is also not clear that the IMF's existing programmes are fitted to and commensurate with South Africa's needs as a middle-income country. The most obvious candidate is the IMF's Rapid Financing Instrument (RFI), under which South Africa could access (normally) 50% of its SDR3bn quota, equivalent to a little more than R37bn, at a 1.5% USD interest rate. However, the RFI is designed for countries with balance of payment difficulties, and it requires countries to have their debt on a sustainable path in order to access the facility. It is not clear how the IMF would view an application for funding from South Africa in this light. Moreover, there are segments of the governing alliance that have already expressed opposition to any type of IMF bailout, instead arguing that South Africa should tap into its domestic savings pools instead. Finance Minister Mboweni has said that South Africa will not take any IMF money that comes with strong conditionality. As South Africa's financing needs mount, this debate about IMF versus prescribed assets will continue to bubble away in the body politic.

Current account deficit set to narrow but capital account remains under pressure

A 'sudden stop' in global capital markets has triggered large outflows from emerging markets

Global financial markets have been characterised by a big deterioration in risk sentiment in recent months, responding to mounting concerns about both the economic and financial impacts of the COVID-19 pandemic to the global economy. This adjustment has triggered large capital outflows out of emerging markets as investors seek 'safe haven' assets. South Africa, with its relatively open capital account, has not been spared from this 'sudden stop'. In this riskier global environment, external vulnerabilities as a source of macroeconomic risk will likely remain a key concern for investors. In this regard, South Africa's balance of payments current account data appear to be showing some adjustment. In the final quarter of 2019, the current account deficit narrowed to just 1.3% of GDP, its smallest level in nearly a decade, and we think that this trend has continued into 2020. In January, the merchandise trade data delivered a deficit of R1.9bn, which is quite small given the usual strong negative seasonal effect in the month. The February data also showed a strong merchandise trade surplus of R14.2bn. Even with an assumption of a March outcome more or less in line with seasonal trends (i.e. a surplus of about R10bn), the seasonally adjusted and annualised merchandise trade surplus would come in at R123.1bn (or 2.3% of GDP). Under an assumption that the balance on net income payment, service and transfers is broadly unchanged, this would push the current account deficit down to 1.1% of GDP in Q1 20.

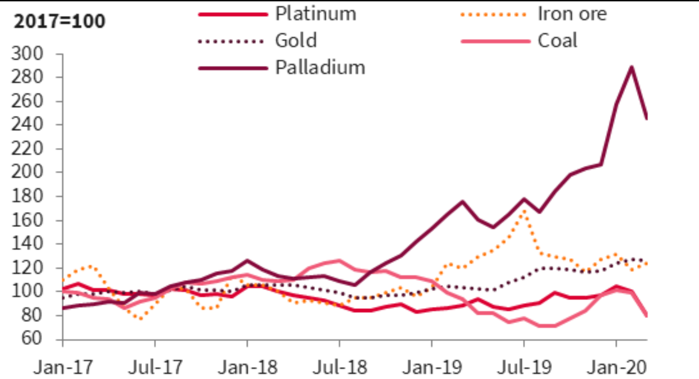
South Africa's export commodity prices have risen in recent months but some could come under pressure as global growth softens

One of the driving forces behind the improvement is a lift in the terms of trade. South Africa's key export commodity prices were broadly well supported through most of Q1 20. On average, gold prices were 6.6% higher compared with Q4 19 as the commodity benefitted from 'safe haven' asset buying. Across the PGM basket, there were strong price increases with the average price of palladium rising by 27% q/q, while rhodium was up by 78.8% and iridium was up slightly by 1.1%, but average platinum prices fell by 0.9% q/q. Meanwhile, the average prices of coal and iron ore increased by 8.2% q/q and 1.2% over the same period, respectively. However, some of the commodities will struggle to hold on to these gains as global economic activity slows. For instance, rhodium prices were down nearly 30% in the first two weeks of April alone while coal and iron ore prices fell by 15.8% and 5.0% over the same period, respectively. Moreover, the price effect is not the only consideration on the export side. Trade volumes are likely to dwindle as COVID-19 shrinks global merchandise trading activity and disrupts supply chains. As we noted earlier, the WTO estimates that world trade could shrink by as much as 32% this year.

The sharp decline in Brent crude oil prices is a favourable development for South Africa

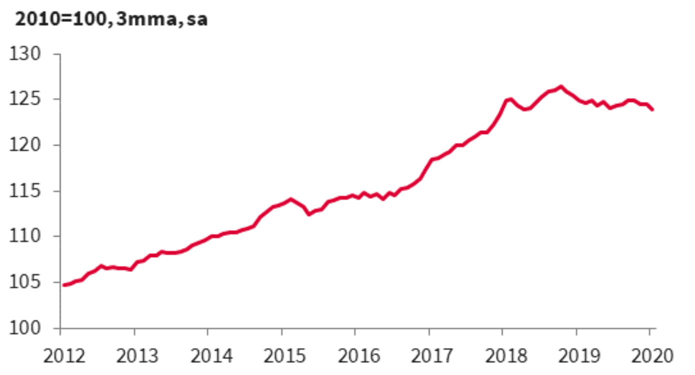
On the import side, the recent collapse in the Brent crude oil price is a favourable development for South Africa given that oil imports accounted for 10.6% of the total import bill in 2019, while net refined petroleum products accounted for a further 1.8%. After touching its lowest level in more than two decades at the start of this month, prices have bounced back higher as some of the world's major producers of oil have agreed to cut output but slipped back below USD20/bbl at the time of writing. However, despite this, relatively low Brent crude oil prices are likely to persist in the face of weak global economic activity. Moreover, the weakness in domestic demand is likely to compress non-oil merchandise imports. In South Africa, fixed investment tends to be strongly import-intensive and our projected decline of nearly a fifth in gross fixed capital formation in 2020 will serve to shrink the merchandise import bill. Additionally, many consumer goods are imported, and thus the collapse in household spending in 2021 will also contribute to lower imports, in our view.

Figure 9: Commodity prices likely to be subdued in 2020 due to COVID-19



Source: Refinitiv, Absa Research

Figure 10: Global trade volumes likely to ease further



Source: World Trade Monitor, Absa Research

Dividend and interest payments and receipts will be key to watch in the current account evolution

Large net shifts might be also expected for factor payments, mainly cross-border dividends and interest flows. Substantial portfolio disinvestment from South Africa's equity and to a lesser extent bond markets from Q2 18 onwards (Figure 11) should significantly reduce dividend and interest outflows, which averaged over 5% of GDP in 2019. Of course, South Africa's dividend and interest receipts from abroad will likely also take a knock from the global recession, but these were only half as big as outflows to begin with (2.3% of GDP in 2019), and the knock to these hard currency receipts will be partly offset by exchange rate depreciation, unlike outflows. On balance, we think net factor payments should improve in South Africa's favour.

We forecast a current account deficit of 1.6% of GDP in 2020, rising to 2.4% of GDP in 2021

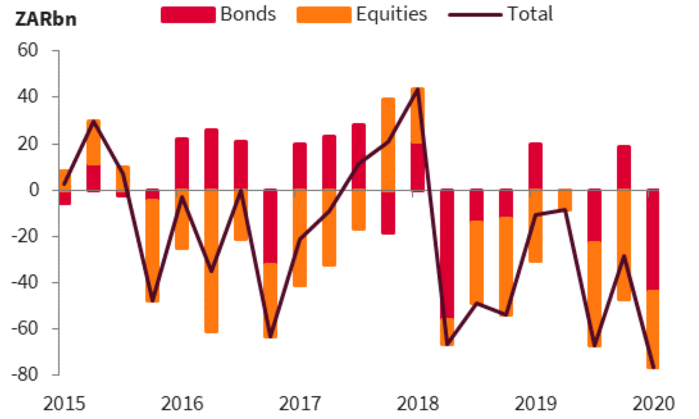
Elsewhere in the invisibles component of the balance of payments, we see little net change. Travel service receipts, which accounted for roughly half of all service receipts in the current account in 2019, are likely to shrink significantly given the lockdown and likely glacial recovery of global tourism thereafter. However, this tourism stop works in the opposite direction as well, and so the net effect on the service balance could be fairly small. Overall, we believe that the combination of the effects of commodity price trends, shrinking global merchandise trade and significantly weaker domestic demand will be an important driver of the current account balance. On balance, we see these factors delivering relatively modest current account deficits of 1.6% of GDP in 2020 and 2.4% of GDP in 2021.

South Africa continues to run a positive net international investment position

In a global environment with elevated uncertainty, the financing side of the balance of payments is also critical, particularly given South Africa's general reliance on portfolio flows to fund its current account deficits. Net foreign direct investment remains relatively modest. Although there was a slight pick up during 2019, it could moderate this year as firms around the world prioritise preserving cash. Meanwhile, portfolio investments have seen large outflows thus far this year.

According to the JSE data, foreigners sold R32.7bn worth of South African equities in Q1 and R43.7bn worth of government bonds (Figure 11). But even in these turbulent times, we note that South Africa continues to run a positive net international investment position (see Figure 12), although this has weakened over the past year.

Figure 11: Portfolio outflows were big in the first quarter



Source: JSE, Absa Research

Figure 12: South Africa's investment buffers deteriorated in Q4 19

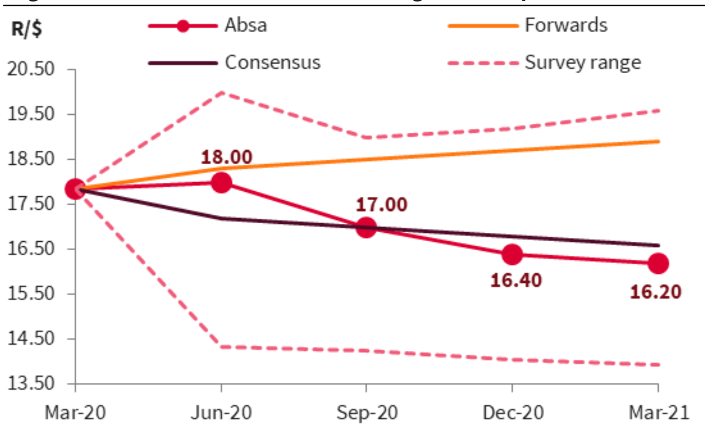
Source: SARB, Absa Research

Rand has weakened a lot already; recovery likely once pandemic is under control

We expect USDZAR to hit 18 by mid-year, but then recover towards year-end

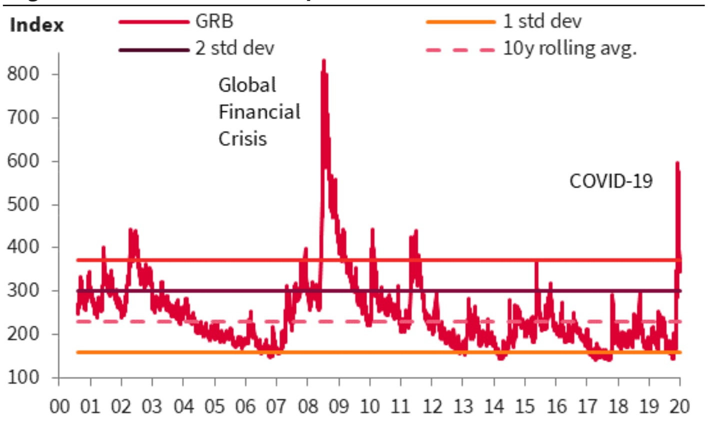
In the short term, the ZAR remains susceptible to heightened levels of risk aversion associated with lingering COVID-19 fears (Figure 13). Moody's latest downgrade of SA's credit rating to sub-investment grade should also keep the ZAR on the back foot over the coming weeks because WGBI trackers could still offload between USD2-8bn worth of SAGBs by the end of April. Equity inflows are also likely to remain scant unless SA is able to avoid a protracted recession. That said, the trade-weighted ZAR remains 17% undervalued on a purchasing power parity basis and our Peer model implies that the ZAR is oversold relative to its high-yielding and commodity-based currency peers. The fact that this year's ZAR weakness could oblige local asset managers to repatriate some of their offshore holdings in order to stay within prudential limits (see *We still believe that ZAR will be at R18.00/USD by mid-year,* 7 April), should also be conducive to a ZAR recovery over the coming quarters. Specifically, we expect the ZAR to be at R18.00/USD by mid-year before strengthening to R16.40/USD by the end of the year (Figure 14).

Figure 13: We believe USDZAR should strengthen once pandemic is over



Source: Bloomberg, Absa Research

Figure 14: Risk aversion has hit peaks not seen since GFC



Source: Bloomberg, Absa Research

Inflation: negative demand shock to cause a downside breach of target

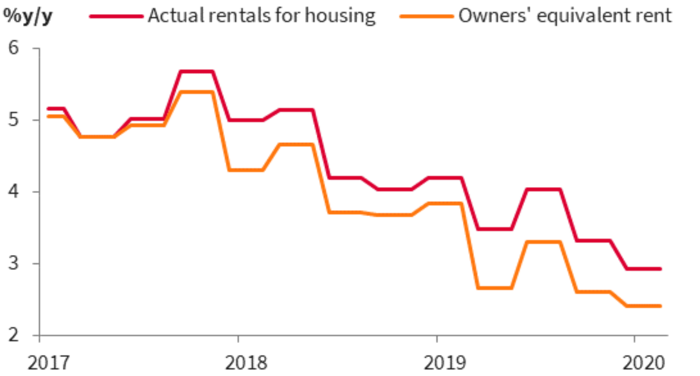
Inflation has been subdued but the multiple shocks of lower oil prices, a weaker exchange rate and softer demand complicate the outlook

After hitting 10-year lows in Q4 19, South Africa's headline CPI inflation rose modestly in Q1 20. In February, headline CPI inflation touched 4.6% y/y from 4.5% in January and an average of just 3.8% in Q4 19. However, the recent increase owes much to narrowly based adverse base effects working via fuel prices. Outside of this, there is little broad-based upward impetus on prices with core CPI inflation remaining just below 4% into 2020. However, recent developments have presented multiple shocks to South Africa's inflation dynamics, complicating the outlook. Positively, Brent crude oil prices have fallen sharply, but adversely, the exchange rate has depreciated significantly. At the same time, the prospect of an even weaker economy will dampen demand-pull pressure on pricing even further. The magnitude of these shocks is unusually large and some of them are still evolving, which introduces a high degree of uncertainty in our forecast.

Brent crude oil prices, electricity tariffs and food prices are important supply-side drivers of CPI inflation

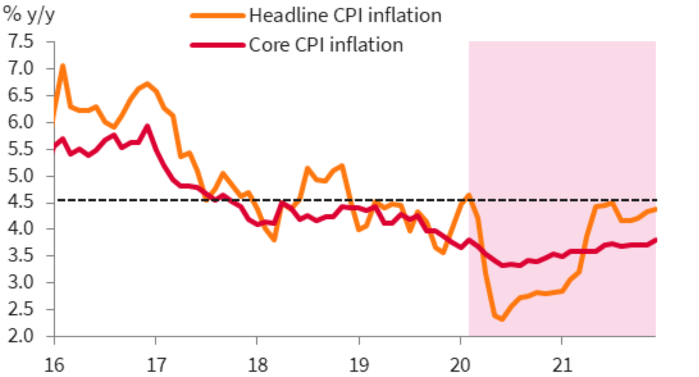
As we note above, fuel inflation can have an important bearing on the overall trajectory of headline inflation, despite its relatively small weight (4.58%) in the CPI basket. Current Brent crude oil prices below USD20/bbl seem perhaps unsustainable. We have thus assumed an average of USD25/bbl for Q2 20, rising to an average of USD30/bbl in Q4 20. Accounting only for direct effects, over a 12-month period, a USD10/bbl deviation from our baseline would imply a CPI inflation average that is 0.3pp symmetrically different compared to baseline. Another important part of energy costs is electricity tariffs. Our assumptions for electricity costs are unchanged with an 8% hike pencilled in for July, but the court ruling in early March to allow Eskom to recoup R29bn that was previously disallowed by the National Energy Regulator of South Africa (NERSA) and other ongoing court processes pose upside risks to electricity costs over the medium term. On food inflation, a strong harvest this year will likely keep price pressure contained. We therefore expect food price inflation to average 4.3% this year, compared with 3.4% in 2019.

Figure 15: Housing inflation could fall further amid weaker demand



Source: Stats SA, Absa Research

Figure 16: Headline CPI inflation looks contained in the near term



Source: Stats SA, Absa Research

Weak demand is likely to keep price pressures generally contained

Outside of the supply-related factors we discussed above, there is a further key question of how the recent exchange rate depreciation will feed into domestic consumer inflation. We believe that the effects of the weaker exchange rate will be more than offset by a sharp slump in demand. Outside of food, fuel and electricity, which we have discussed above, we find that a little more than two-thirds of core CPI inflation is made up of services, which are non-tradeable, while the balance is goods. Across the goods basket, some of the largest components, such as vehicles and clothing will likely be hit by a strong demand shock in a much weaker economy. Meanwhile, across services, the one category worth watching closely is housing. Actual rentals and owners' equivalent rent inflation (which have a combined weight of 16.8% in the CPI basket) have fallen sharply in recent years to just 2.9% and 2.4% y/y, respectively, and we believe that the COVID-19 effect on jobs and demand will exacerbate this trend. The March CPI release, which contains the quarterly housing cost survey, will be key; StatsSA is aiming to publish this data on 29 April. On balance, we see headline CPI inflation continuing to track broadly around the mid-point of the target range over the forecast horizon. In the near term, we expect headline CPI inflation to fall to about 2.5% y/y in the near term due to the effect of fuel inflation, likely averaging 3.1% in 2020 before rising to average of 4.0% in 2021.

Monetary policy: we expect the SARB to cut rates further by 50bp

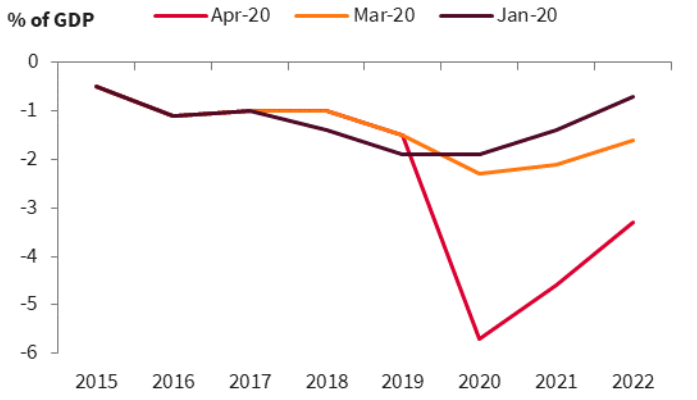
The SARB implemented an emergency 100bp rate cut at its March meeting and another one of the same magnitude at an out-of-cycle meeting earlier this week…

Prior to the March MPC meeting, monetary policy decisions had been driven by the countervailing needs to offset the weak growth environment and further anchor inflation expectations around the mid-point of the target range, at the same time taking into account a variety of domestic and international risks. However, mounting evidence that the COVID-19 pandemic would cause an unprecedented shock to the domestic and global economies changed many of these underlying considerations, pushing the monetary policy reaction function into 'emergency mode'. Similar to many other central banks around the world, the SARB's response was swift and broad. At its March meeting, the MPC cut the repo rate by 100bp, and followed up with another 100bp out-of-cycle cut earlier this week, taking the repo rate to 4.25%, its lowest level ever in the inflation-targeting era. At a nominal 4.25% now, the real repo rate (adjusted by inflation expectations) is slightly negative.

…and announced a range of other measures to ease liquidity constraints in domestic financial markets

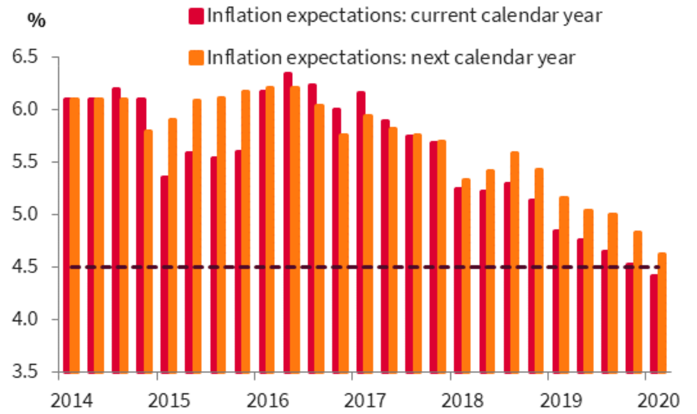
Just a day after the conclusion of the March MPC meeting, the SARB also began announcing a range of other policy interventions to ease liquidity constraints in the domestic financial market. On 20 March, the SARB announced changes to its liquidity management strategy to ease constraints within the domestic banking system. On 25 March, the SARB announced further adjustments to its liquidity management strategy and announced a plan to purchase government bonds in the secondary market. In addition to this, the SARB's Prudential Authority relaxed banks' capital requirements, which the central bank estimated would allow South Africa's commercial banks to lend an extra R390bn or so to the private sector, provided there was demand for credit. These ancillary support efforts are unprecedented in scale and scope, a clear indication of the unusual times.

Figure 17: SARB's output gap estimates have widened dramatically



Source: SARB, Absa Research

Figure 18: Inflation expectations have eased, giving the MPC room to act



Source: BER, Absa Research

The size of the output gap and ongoing downside inflation and growth risks warrant further accommodation

We believe that the SARB has scope to deliver still further monetary policy accommodation. Fortunately, perhaps, South Africa is nowhere close to the zero bound for nominal interest rates, and if inflation surprises to the downside, or activity shrivels beyond expectations, then further rate cuts are likely. However, even without big downside inflation or growth surprises, we think the SARB will likely cut somewhat further, because at this juncture the costs of not doing enough are so much greater than the costs of doing too much. As we have argued, the magnitude of the recession that South Africa is likely to suffer suggests that economic activity could take more than two years to return to pre-2020 levels. This means that the output gap will remain sharply negative for an extended period. At the latest April meeting, the MPC expected the negative output gap to be 5.7% of GDP in 2020, remaining as wide as 3.3% of GDP by 2022. Of course, the five-week lockdown and the business failures that are inevitable, suggest that South Africa's potential growth has also declined, but as an unobservable variable that must be intuited out of the observable data, potential growth is exceptionally hard to get a clear read on. The SARB estimates that South Africa's potential growth in 2020 has collapsed to -2.1%. Still, regardless of the precise number, it seems clear the economy will be running significantly below potential for some time, with dovish implications for monetary policy.

We expect the SARB to cut the repo rate by a further 50bp in May

Inflation is also well contained. The dampening effect of the negative demand shock from COVID-19 and lower Brent crude oil prices will likely more than outweigh the effects of a weaker exchange rate on headline CPI inflation, a point made also by the MPC in its statement. Positively, inflation expectations also appear broadly anchored around the mid-point of the SARB's target range and have continued to ease in the most recent survey. In the Q1 20 BER inflation expectations survey, average expected inflation for this year was just 4.4%, while the average expected for the next year was just 4.6%. A combination of falling inflation expectations and shrinking economic activity is likely to add further downward pressure on wage inflation. An environment where inflation is not a big concern gives the SARB more scope to focus on the yawning output gap. Against this backdrop, we expect the SARB to cut the repo rate further by 50bp this year, most likely in May, but possibly later if near-term developments are less negative than expected.

Structural reform urgency remains; more rating downgrades loom

Renewed commitment to structural reform is needed to stave off further credit rating downgrades

With both Fitch and Moody's having downgraded recently (the latter removing South Africa's last investment grade rating), we warn that further downgrades are likely this year, given the impact of COVID-19 and the weak policy settings and economic performance even before the pandemic hit (Figure 19). South Africa will need to wrestle its enormous budget deficit down, and implement a raft of growth-boosting structural reforms to avoid further deterioration, and it will have to do so from a much weaker starting point. Presently the pandemic is a big distraction from the reform agenda, but there are signs that the government intends to 'not let a good crisis go to waste', essentially using the urgency of the crisis to implement policies that were previously impossible. For example, the government has declined to provide any further bailout funding for loss-making South African Airways and SA Express, which essentially means that they will be liquidated, in our view.

Figure 19: More rating downgrades are likely unless South Africa can accelerate structural reform

	S&P	Moody's	Fitch
Foreign currency	BB	Baa3	BB
Local currency	BB+	Baa3	BB
Outlook	Negative	Negative	Negative
Date ratings changed	3-Apr-20	27-Mar-20	3-Apr-20
Date outlook changed	3-Apr-20	27-Mar-20	3-Apr-20
2020 scheduled review dates	22 May and 20 Nov.	20 Nov.	Unknown, perhaps end Oct. or early Nov.

Source: S&P, Moody's, Fitch, Absa Research

A handful of big structural reforms could make a big difference to South Africa's growth prospects

We see four reforms as particularly critical over the next year to lifting business confidence, boosting growth and avoiding further credit rating downgrades. The first is securing electricity supply in a liberalised market. The government is now awaiting concurrence from the regulator on its plans. The second is securing regulatory certainty in the key mining sector, in part via an agreement on the 'once empowered, always empowered' standoff that is preventing agreement on the Mining Charter. The third is opening up the visa regime for skilled foreigners once the travel ban is lifted. The fourth is the auction of the broadband spectrum.

The COVID-19 pandemic could also profoundly shift the thinking of both the government and the private sector in a number of important policy areas, including especially National Health Insurance. Still, it remains exceptionally difficult to see how this scheme, despite its moral and social merits, can be financed. So far, the crisis has not sparked any evolution in the governing alliance's thinking about labour market shibboleths, but reformers in the ANC must understand that increased labour market flexibility is key to job creation. Perhaps, moves towards this could be offset by a fresh look at basic universal income approach to social welfare, especially if firms lay off lots of workers and growth is slow to recover. The proposal to top up social grants for the duration of the crisis could mark a step in this direction.

COVID-19 could shake South Africa's politics

Reformers within the ANC could get a boost from the government's adroit handling of the crisis so far, but only if the lockdown does not last too long

South Africa's fractious politics might conceivably benefit from the pandemic to the extent that the government's adroit management of the public health aspects of the crisis could boost the popularity of President Ramaphosa and his team of reformers, giving them an upper hand over the opposing faction within the ANC. This might allow them to drive faster structural reforms, but this is a hope, rather than a certainty. The longer the lockdown lasts or the more brutal the economic fallout, the more impatient and frustrated the population could become, with potentially adverse consequences for South Africa's dysfunctional politics. It is unclear at this stage if the governing ANC will be able to hold its planned mid-term National General Council sometime around mid-year, given the likely ban on big gatherings. Ramaphosa's opponents allegedly plan to push for a negative review of his performance in terms of implementing ANC policies agreed at the National Conference, in 2017 including NHI and the nationalisation of the SARB.

We can only dimly apprehend the look of the post-coronavirus world

The uncertain progress of the disease internationally and of the economic costs of the measures being taken by various national governments generate big downside risks for South Africa

The fact is that after this unprecedented shock, the world and South Africa face extraordinary uncertainty. No one knows for sure how long the pandemic will last, nor how long countries will have to continue with stringent social distancing and its terrible economic costs, nor what the cumulative effect of the economic aftershocks will bring. COVID-19 will force profound social, political and economic changes globally and in South Africa, and we can only dimly apprehend what this means. The era of hyper-globalisation is almost certainly over. Nations may look to insure themselves by seeking self-sufficiency in terms of supply of foodstuffs and medical supplies. Firms will rush to automate, and many types of work will remain online. In the interests of public health, governments may seek increased control over the lives of their citizens. Materialistic consumerism may not survive. Some countries are likely to come through this crisis in a much stronger relative position than others. For South Africa, with its scant fiscal space, somewhat limited bureaucratic capacity and ongoing socio-political divides, all of which hobbled the country even before COVID-19, the prognosis does not appear very encouraging. However, it is early days still. Perhaps the challenge of COVID-19 will pull the nation together in a way that leaves it better placed afterwards to deal with its multiple challenges. Though, right now it is simply too early to know.

Figure 20: Assumptions are key to the outcomes of any forecasting effort

Variable	Absa Research assumptions (April)	SARB assumptions (April 2020 MPC meeting	General comments and risks to our assumptions
Key Global Economic Assumptions			
Global growth	We forecast G7 GDP contraction of 4.0% for 2020 and growth of 1.6% for 2021; China GDP growth of 1.1% and 6.2% for 2020 and 2021, respectively.	Growth of SA's major trading partners is projected to be at -2.8% in 2020 and 4.0% in 2021.	The Absa Research and SARB global growth assumptions for model inputs are not strictly comparable. However, both sets of forecasts project GDP contractions in major trading partners in 2021.
Brent crude	Brent to average USD34/bbl in 2020 and USD37/bbl in 2021.	Brent to average USD37/bbl in 2020 and USD45/bbl in 2021.	Absa's crude price assumption is lower than that of the SARB but there is considerable uncertainty about the outlook of international oil prices.
Non-oil commodity prices	Our commodity forecasts for 2020 and 2021 as a base: Gold in USD/oz at 1,584 and 1,585; Platinum in USD/oz at 768 and 725; Coal USD/mt at 75 and 73; Iron ore in USD/mt at 83 and 81.	The SARB does not reveal any specific commodity price assumptions. Instead, it assumes international commodity prices to fall by 7.1% and rise by 5.4% in 2020 and 2021, respectively.	The Absa Research and SARB commodity price assumptions are not strictly comparable. Gold prices could benefit from 'safe haven' asset buying but commodities that are sensitive to the global growth cycle will come under pressure.
Key Domestic Economy assumptions			
Food prices	We forecast food price inflation to average 4.3% in 2020 and 4.6% in 2021 and 4.7% in 2022.	The SARB did not reveal its forecast profile for food price inflation, but noted that food inflation is expected to remain low, in part due to higher domestic production levels.	Crop prices have recently rose and they might exert upward pressure in crop-related parts of the CPI basket. However, the bumper harvest in 2020 is likely to keep overall food price pressures contained.
Fuel taxes and levies	We assume a 10c/l rise in distribution margins each December and a 30c/l increase fuel levies in April 2021.	Taxes and levies on fuel are expected to rise by 5.8% and 5.2% in 2020 and 2021, respectively.	Among other measures, the National Treasury is likely to announce a higher-than-inflation increase in the general fuel levy in the February 2021 budget as a way to lift tax revenues.
Electricity prices	We have assumed average electricity tariff increases of 10.0% for 2020 and 6.6% for 2021.	The SARB expects average electricity increases of 9.6% in 2020 and 6.7% in 2021.	Eskom's court reviews of recent NERSA decisions are an upside risk to electricity tariffs.
Growth in government consumption	We forecast real government consumption (G) growth of 0.0% in 2020 and -0.5% 2021.	The SARB no longer publishes its assumption for G.	The need to stabilise the growth of government indebtedness and the slow pace of economic growth will limit the growth of government consumption.
Potential growth	0.5% in 2020 and 0.8% in 2021.	-2.1% in 2020 and 1.1% in 2021.	Assumptions about potential GDP growth are tricky as they cannot be directly observed, but instead estimated by using statistical techniques on recent GDP trends. We and the SARB expect the negative output gap to persist over the forecast horizon.
Neutral real interest rate	Absa's model makes no explicit assumption about the neutral real interest rate.	The neutral real interest rate is estimated to be 2.1% in 2020 and 2.2% in 2021.	Globally, there is much debate about what the neutral level of real rates is because it cannot be directly observed. However, weaker global economic activity due to the COVID-19 pandemic has probably lowered the neutral real rates everywhere.
Exchange rate	In Absa's macro model, our exchange rate serves as an exogenous input. Our baseline forecast assumes a NEER depreciation of 12.1% in 2020 and appreciation of 2.8% in 2021.	The SARB's QPM model endogenously determines the exchange rate path, forecasting a NEER depreciation of 13.8% in 2020 and of 0.1% in 2021.	The exchange rate is one of the most key variables in any forecast, regardless of whether it is set as an exogenous assumption or endogenously determined, as with the SARB's new QPM. The volatility of the rand and the uncertainty about its path over the forecast horizon pose risk to the model's forecast.
Interest rates	We expect the SARB to cut the repo by 50bp to 3.75% in July 2020.	The SARB's QPM run done just before the April rate decision embedded five 25bp rate cuts over the forecast horizon.	The FRA market is fully discounting a 25bp repo rate cut by Q2 20 at the time of writing. With a divided MPC, calling its decisions is difficult.

Source: SARB, Refinitiv, Bloomberg, Absa Research

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