South African Economic **Outlook 2020**

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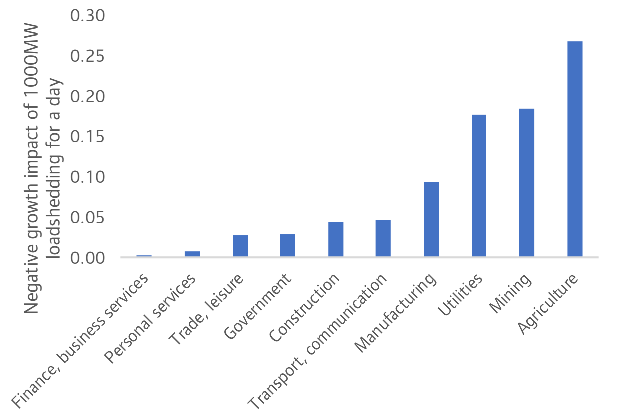
10 February 2020

SA economic growth: political hostage

In a nutshell: politicians and Eskom key 2020 growth determinants

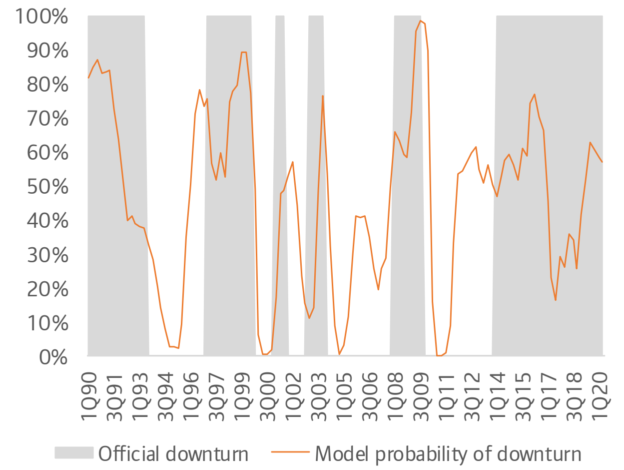
The fiscal and electricity crises clearly mean that government should not delay decisive policy reforms. Thus far, government's growth-supportive adjustments have comprised focused, uncontentious policy steps, which haven't been adequate to lift confidence from its lowest levels in decades. The marginal growth improvement that we foresee in 2020 to a large extent reflects an assumption that the weakness or contraction in select sectors will ease, rather than any meaningful new growth impetus. This is premised on a similar magnitude of electricity load-shedding to 2019. While there are many caveats and reasons for non-linearity, we estimate that every day of stage one (1,000 MW) load-shedding reduces annual economic growth by around 0.015%.

Figure 1: Load-shedding impact – goods-producing sectors typically hit hardest



Source: SARB

Figure 2: Econometric business cycle model still estimates more than even chance of very weak growth through 1H20



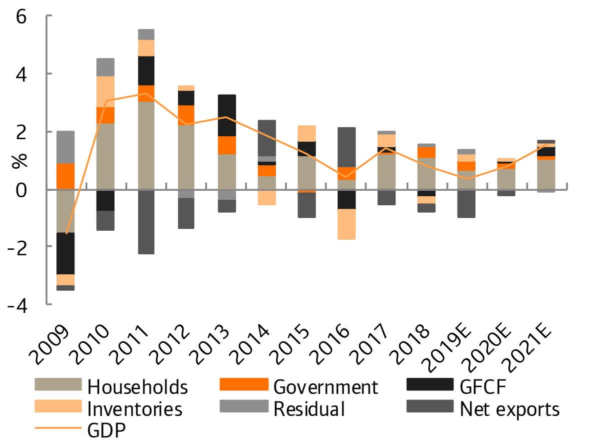
Source: SARB, Standard Bank Research

At the end of 2019, government invited private sector proposals by January 2020 to add 2,000 – 3,000 MW of least-cost new generation capacity, while there should also be around 2,400 MW of new generation capacity from Eskom and the latest round of renewable energy. The crux, however, is in the operational performance of the existing plants, which operated at an energy availability factor (EAF) of only 56.8% at the beginning of 2020. Eskom foresees no load-shedding if unplanned outages don't exceed 9,500MW, though at 11,500MW it foresees likely stage one to two load-shedding in 1Q20 (early in 2020 this was as high as 14,000 MW).

The electricity shortfall clearly poses a major risk to the private sector's fixed investment trajectory, though we still assume that there will be gradual traction with the commitments made during the presidential investment summits and Public-Private Growth Initiative (PPGI) as well as ongoing roll-out of the renewable energy independent power producers' (REIPP) capex. Sovereign credit downgrades from all the major credit rating agencies are on the cards in 2020, which might also weigh on confidence, though we are more concerned about the negative confidence and growth ramifications if government doesn't decisively reduce concerns about fiscal sustainability and Eskom than we are about the impact of the rating downgrades per se.

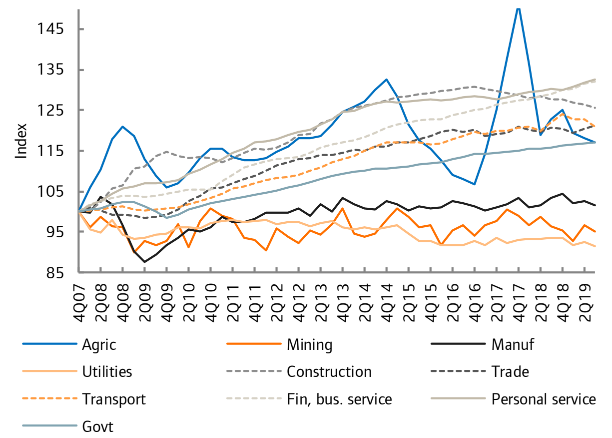
From a supply-side perspective, growth should mainly be driven by the services sectors in 2020, given our assumption that the electricity supply constraint will continue to curb growth in the goods-producing sectors. Our forecasts incorporate a marginal improvement in the contribution from the agricultural sector, though this is at risk as rainfall forecasts continue to weaken (see analyst Penny Byrne's report It never rains but it pours). The mining and manufacturing sectors are to a large extent at the mercy of Eskom's operational performance.

Figure 3: Growth still driven by consumer momentum



Source: SARB, Standard Bank Research

Figure 4: Growth driven by services sectors

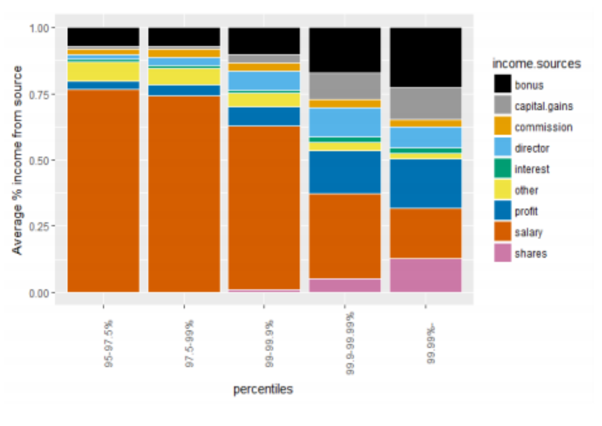


Source: SARB, Standard Bank Research

Consumer spending: a fragile, uneven growth contributor

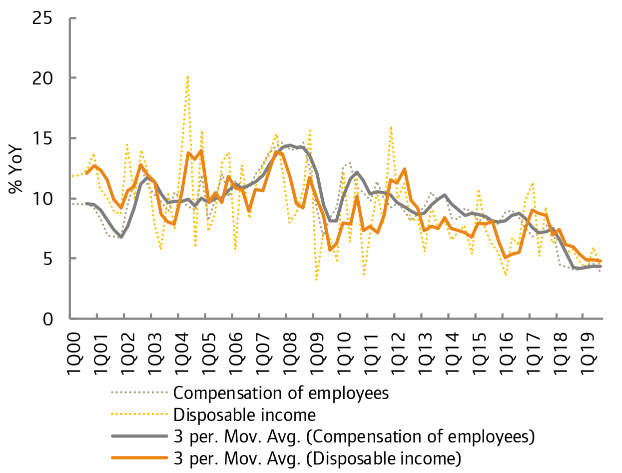
Consumer spending growth is still supported by real income growth despite our growing concern about the weakness in employment as well as skilled emigration. Higher-income earners seem to continue playing a disproportionate role in driving aggregate consumer spending. Their spending power has been, according to our analysis, strongly supported by non-wage income, particularly investment income, and they have also typically received above-average real wage growth in the past.

Figure 5: Composition of households' income – non-wage income constitutes around 50% of top earners' income



Source: Bassier and Woolard (2018)

Figure 6: Non-wage income has been supplementing consumers' wage income (with disposable income growth stronger than wage growth)



Source: SARB, Standard Bank Research

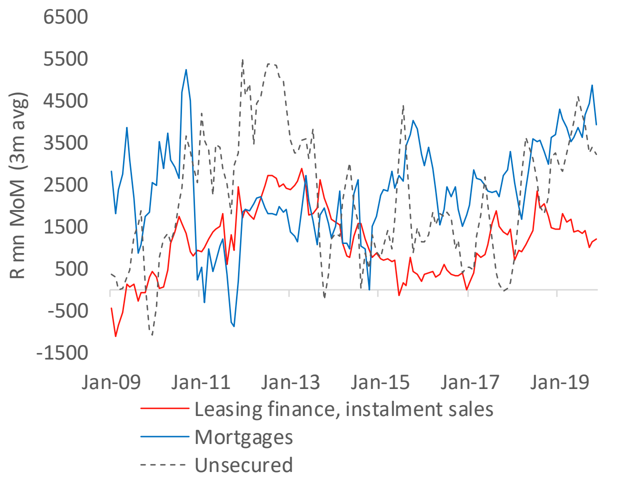
A key driver of consumers' spending power is credit growth, which our analysis[1] suggests is primarily driven by mortgage growth of the higher income groups and unsecured loans of the lower income groups (see Consumers still supported but fragile). There are already signs that the latter group is under pressure, with a growing number of borrowers with reasonably small debt burdens falling into arrears[2]. In contrast, the arrears of high-income borrowers remain quite low and their debt growth has mainly

[1] *Based on data from one of the credit bureaus, which is not nearly as robust as official data and needs to be used with caution.*

[2] *The growth has also been supported by a shift downwards on the credit-score scale, though this seems to have stalled in the latest (3Q19) data.*

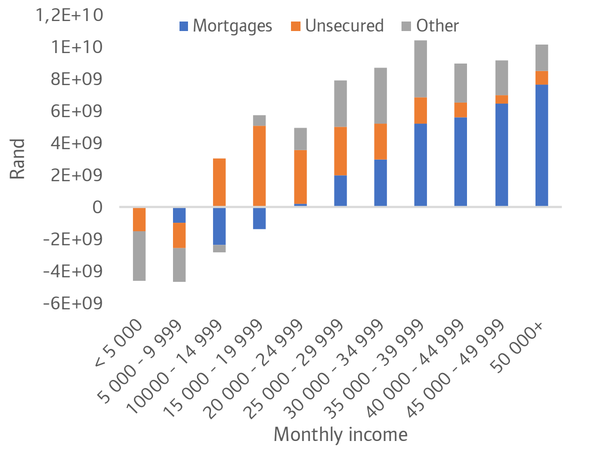
been in respect of mortgages. The credit impulse may thus in due course lose momentum insofar as unsecured loan growth should fade.

Figure 7: Households' (seasonally adjusted) credit growth remains strong, mainly owing to sturdy mortgage growth



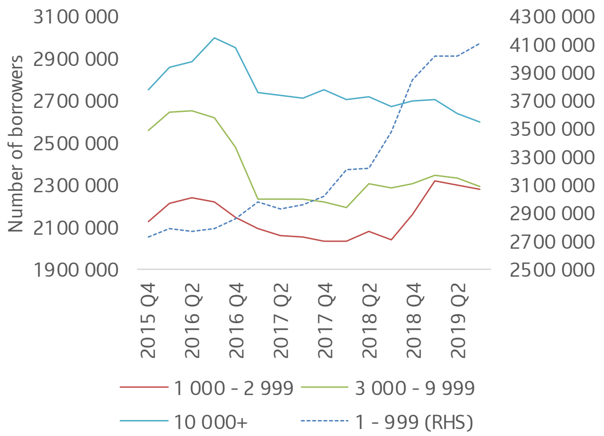
Source: SARB, Standard Bank Research

Figure 8: Household credit fuelled by mortgages of middle- to high-income earners and unsecured loans of low- to middle-income earners



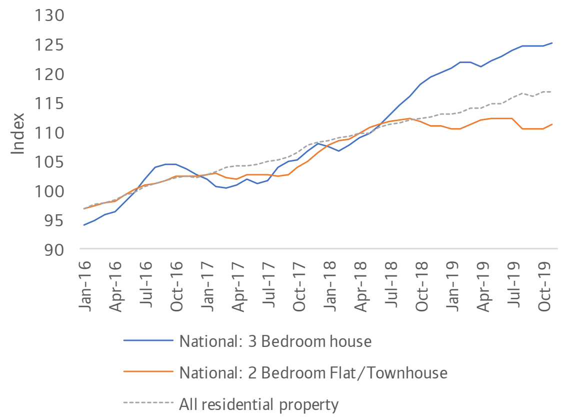
Source: SARB, Treasury, Standard Bank Research

Figure 9: Overdue loans rising most for people with small loan balances, implying stress in lower-income groups



Source: XDS, Eighty20, Standard Bank Research

Figure 10: House price increases stronger for larger houses, consistent with stronger finances of higher-income groups



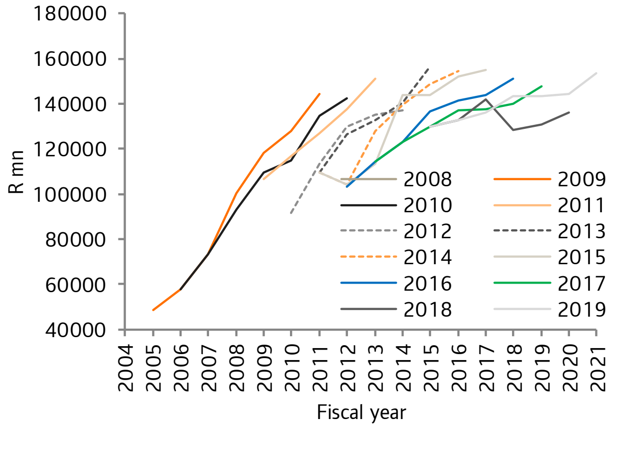
Source: XDS, Eighty20, Standard Bank Research

Fixed investment likely to remain weak and fragile

Public-sector infrastructure spending growth is likely to remain weak in the short to medium term, with constrained SOE funding positions, limited fiscal space, long-standing capacity constraints and unintentional delays created by anti-corruption efforts. The growth in infrastructure spending will be modest – only 2.8% YoY in 2020 – if *all* the projected capex takes place (without any underspending, which may very well continue). This is consistent with the prevailing weakness in construction companies' perceptions of activity levels. We remain optimistic about an increase in private sector participation in infrastructure construction (and potentially maintenance and operations) of which the first concrete steps have manifested in the Infrastructure Fund allocation in the 2019 MTBPS. The profile of the Infrastructure Fund's spending –

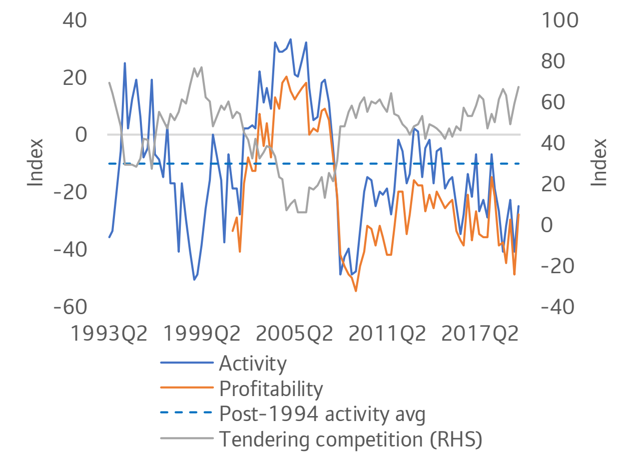
which starts very modest before growing in the longer term[3] – aptly reflects how slow this process will likely be.

Figure 11: Government infrastructure underspending is likely to continue



Source: Treasury, Standard Bank Research

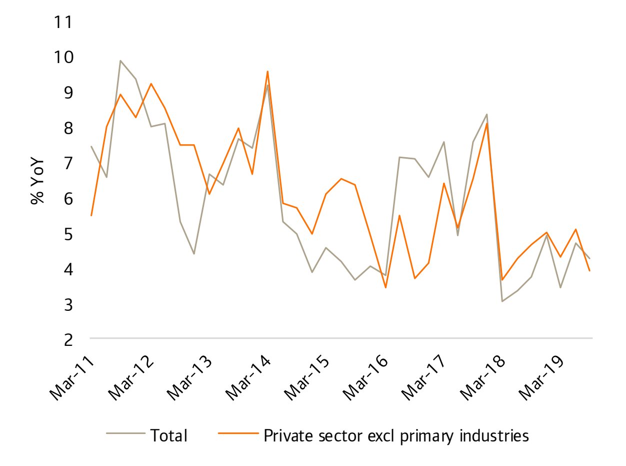
Figure 12: Construction companies' perceptions of activity levels improved but remain weak



Source: BER

Private-sector fixed investment should, as in 2019, again be supported largely by specific projects, notably the renewable energy programme and commitments made at the president's Investment Summits. Our view remains that the popular thesis, that a resumption of maintenance or replacement investment will spur an acceleration in private-sector fixed investment, is misplaced as real capital stock levels continue to rise (in all sectors bar manufacturing). Faster capacity expansion is thus required for a larger economic growth contribution from the private sector's fixed investment.

Figure 13: Gross operating surplus (profit proxy) not providing strong support for fixed investment growth



Source: Stats SA, Standard Bank Research

Figure 14: Private sector fixed investment not low vs total demand

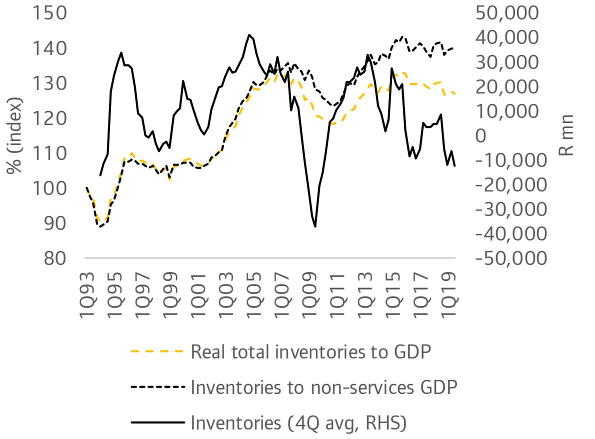
Source: SARB, Standard Bank Research

Inventory restocking unlikely to be a big boost

Inventory destocking has been comparatively mild in the current economic downturn and we expect a similarly subdued restocking cycle to follow. We therefore don't expect any meaningful boost to economic growth from inventory rebuilding.

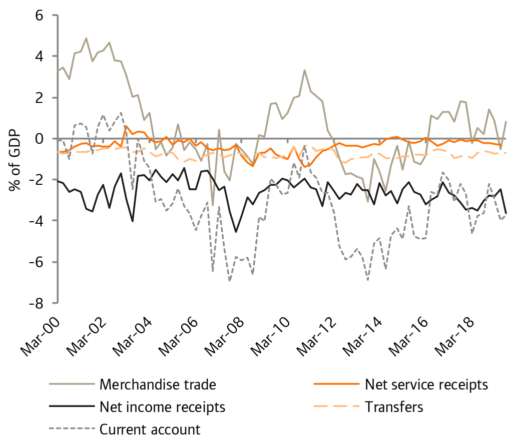
[3] *Government allocated R0.5bn to the fund in FY19/20, with R10bn projected over the three-year forecast period and an ultimate aim of R100bn over a decade.*

Figure 15: Real inventories to GDP not meaningfully lower than at the start of the current official downturn



Source: SARB, Standard Bank Research

Figure 16: CAD supported by trade improvement



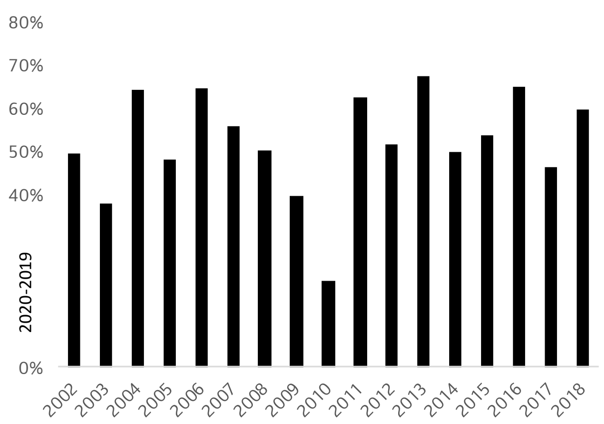
Source: SARB, Standard Bank Research

Trade and the CAD supported but vulnerable

Net (real) trade volumes should benefit from a relatively competitively valued rand in 2H18 – 2019 and the forecast acceleration in SA's trading partners' growth in 2020. Export growth will, however, be capped by the electricity constraint. Imports, meanwhile, will be generally weak given the expected weakness in domestic demand, except for the boost from capex imports related to specific projects such as the renewable energy expansion investment. It is difficult to disentangle the impact of idiosyncratic factors, such as load-shedding, and global factors, such as the trade war, on export weakness. However, our disaggregated analysis of SA exports' global market share underscores the importance of local factors insofar as exports have generally been losing global market share. The strong terms of trade are masking the deterioration in the real goods and services trade balance.

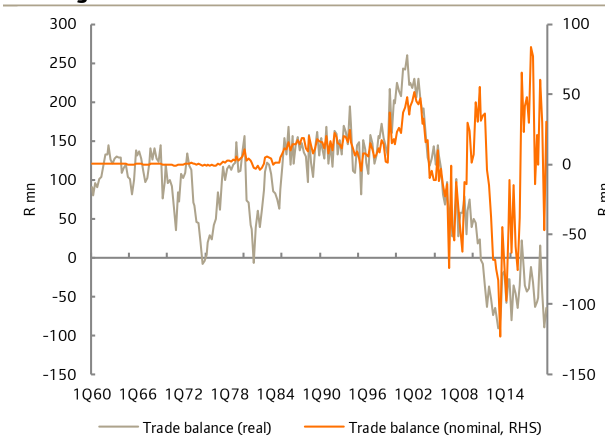
Amid a material improvement in the nominal trade balance, the rest of the current account deficit has deteriorated in recent years. This is largely owing to the widening of the income deficit (comprising investment returns), according to the SARB's (official) estimates, underpinned by the estimated expansion of non-residents' investments in SA. We expect the current account deficit (CAD) to remain reasonably small in 2020 (especially once the SACU payments are excluded).

Figure 17: Proportion of categories losing global market share (YoY) - broad-based global market share losses[4]



Source: Bloomberg, Standard Bank Research

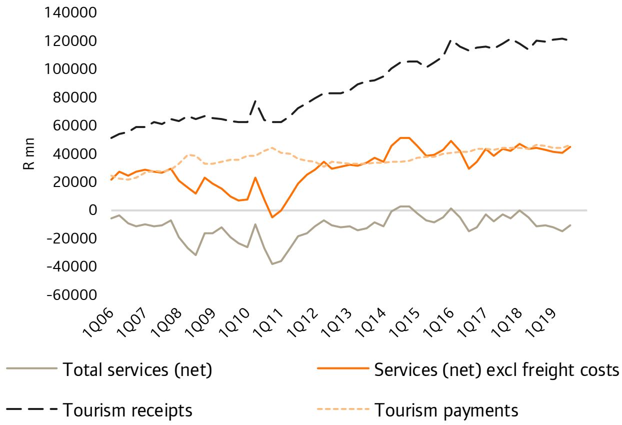
Figure 18: Record-high terms of trade masks the weakness in real goods and services trade



Source: Bloomberg, Standard Bank Research

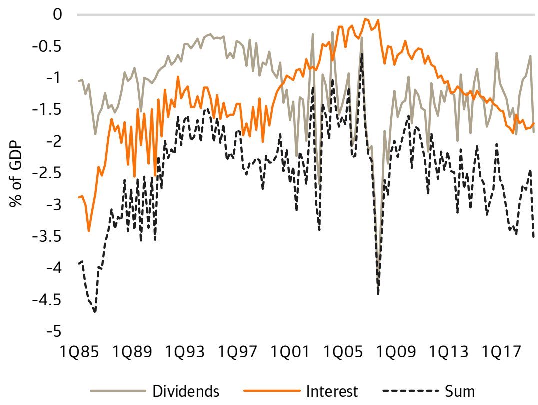
[4] *This is the cumulative impact on revenues from year-to-year market share changes across 255 categories.*

Figure 19: Tourism inflows support the CAD



Source: SARB, Standard Bank Research

Figure 20: Net dividend and interest payments high



Source: SARB, Standard Bank Research

Fiscal and rating risks high

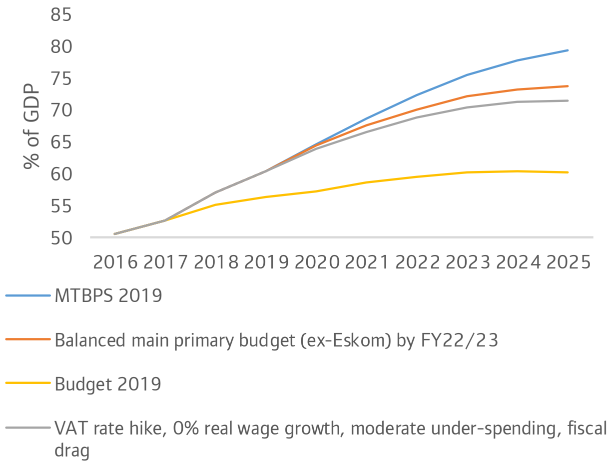
The magnitude of the fiscal shortfall implies that trimming at the edges is no longer adequate, the large expenditure items – specifically the wage bill and ongoing cash injections for SOEs – need to be addressed. Finance Minister Tito Mboweni's tough stance on SOEs and the ongoing pursuit to unwind state capture is encouraging, though we'll only get clear guidance on the political will to resolve the fiscal and SOE problems this year, when the business rescue at SAA unfolds and steps have to be taken to avoid the extent of fiscal deterioration predicted in the MTBPS.

There will obviously be strong opposition from factions within the ruling party and tripartite alliance to any wage bill curbs[5]. While a freeze of government wages, which we estimate could save around R50bn in FY22/23, is one of the proposals to be discussed, we see this as a very improbable outcome. We see CPI-linked wage growth, which will save around R35bn in FY22/23, as a more realistic assumption.

We assume that, through a combination of curbing the wage bill, cutting other spending and hiking taxes, government will achieve Treasury's proposed balanced main primary budget (excluding Eskom) in 2022, though this cannot be taken for granted. Even full implementation of the proposed adjustments will still see the government debt-GDP ratio rise to above 70% (*ceteris paribus*). The debt servicing cost will increase to around R300bn by FY22/23 from around R200bn in FY19/20 – this compares to annual social grant spending of around R210bn - R220bn and around R160bn of total government infrastructure spending. Clearly, such a debt service burden, which excludes the impact of the planned National Health Insurance (NHI) and transfer of Eskom debt onto the government balance sheet, is undesirable and sub-optimal spending (see MTBPS: further thoughts).

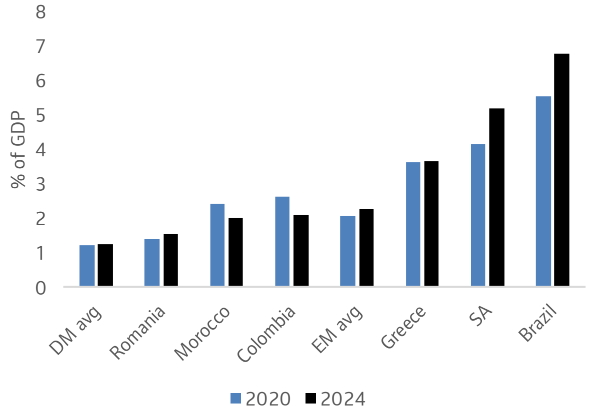
[5] *The current wage settlement extends through FY20/21, so we rule out cuts to the wage bill in 2020 though subsequent forecasts may be trimmed.*

Figure 21: Government debt should settle below MTBPS forecasts, though unlikely below 70% of GDP



Source: Treasury, Standard Bank Research

Figure 22: SA debt servicing cost high in absolute and relative terms



Source: Treasury, Standard Bank Research

Treasury strongly argues that, apart from addressing the remaining fiscal leakage, spending cuts are increasingly challenging following several years of trimming, though it foresees some savings from suspending the implementation of new transport networks in planning stage for over a decade without roll-out of services to residents; consolidating entities and regulatory agencies; disposing of unused land and other assets; and curbing benefits received by political office bearers through Ministerial Handbook reforms. We also foresee further modest capex underspending.

At the same time, government is increasingly reticent to increase taxes following several years of hikes and a general acknowledgement of its inefficient spending. Nevertheless, we foresee more tax hikes this year and, despite households' tax burden rising to the highest in decades, this will likely be borne largely by consumers. This will include near-full fiscal drag (not adjusting tax brackets for inflation), supplemented by modest revenues from higher excise duties on alcohol and tobacco products and fuel levies. There is a strong probability of another VAT rate hike, though we suspect that the president would want to avoid this given the political capital that he will have to spend on other politically unpopular reforms such as SOE overhauls and a reduction of the government wage bill. Dividend or capital gains tax might also be increased, rather than to impose an administratively challenging wealth tax.

Figure 23: Select tax hike options and considerations for Budget 2020

Tax	Revenue boost	Probability
Fiscal drag	At least R13bn	Very high probability
Fuel levies	R3bn	Very high probability
Duty on alcoholic beverages and tobacco (jointly)	R1bn	Very high probability
Estate duties and donations tax	R1.3bn for a 10ppt increase	High probability
Medical tax credits	R1bn	High probability
Wealth tax	R5-8bn	Moderate probability
Dividend tax rate	R8bn for a 5ppt increase	Moderate probability
Capital gains tax rate	R2bn	Moderate probability
VAT rate	± R12bn for every 0.5ppt increase.	Moderate probability
Top marginal income tax rate		Moderate probability
Personal income tax rate increase	±R9.5bn for 1ppt increase	Low probability
Graduate tax	R200m – R3bn	Low probability
One-off levy		Very low probability
Company tax rate		Very low probability

Source: Treasury, Standard Bank Research

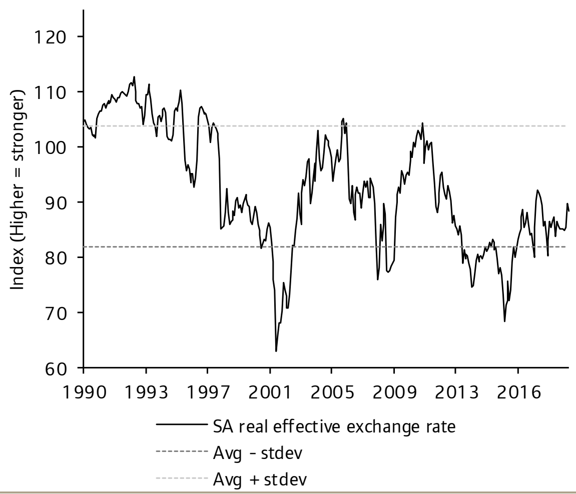
We estimate that the FY19/20 fiscal revenue forecasts are still achievable and, premised on the combination of spending cuts and tax hikes that we foresee, we expect the FY20/21 deficit to be around 6.6% of GDP rather than the MTBPS projection of 6.8%. Further bailouts of SOEs, in addition to the support already announced for Eskom and other SOEs, continue to pose a risk to the fiscal projections, as do the potential liabilities of the Road Accident Fund (RAF) and the elevated unpaid bills and accruals of provincial and local governments. These risks are counteracted by the potential gains from the spectrum auction scheduled for 1Q21, which we don't yet include in our forecasts and which we don't expect Treasury to include in its projections yet. It is difficult to predict when the gains from the improvements underway in SARS's capacity, which Treasury has repeatedly indicated could be sizeable, are likely to materialise. Judge Dennis Davis, who headed the Tax Review Commission, at the end of 2019 said that a "significant closure of the tax gap" is on the cards, which he "didn't think was possible".

We don't expect these consolidation steps to stave off a Moody's rating downgrade to junk. Encouragingly, SA's credit rating is still within the rating range estimated by the Moody's rating matrix. However, the jump in forecast government debt-GDP, even if policy steps lower the trajectory relative to the MTBPS forecasts, significantly worsened SA's metrics compared with peers. Furthermore, Moody's not only lowered its assessment of SA's fiscal stance in its latest assessment, it also lowered the assessment of the susceptibility to event risk. Moody's also flagged the unsustainable gap between SA's expected medium-term growth rate – which it now estimates at only 1 - 1.5% - and the real interest rate, which, in the absence of a primary budget surplus, means that government's debt won't stabilise. We thus see the odds as biased towards a downgrade by Moody's (also see Moody's: final warning and MTBPS: further thoughts). The risk of a downgrade by Fitch is also significant, with that rating placed on negative outlook last year — even before the disappointing October MTBPS. S&P might also downgrade SA's sovereign credit ratings in 2020 (see S&P: negative outlook on SA's worst rating).

Rand within fair range but vulnerable

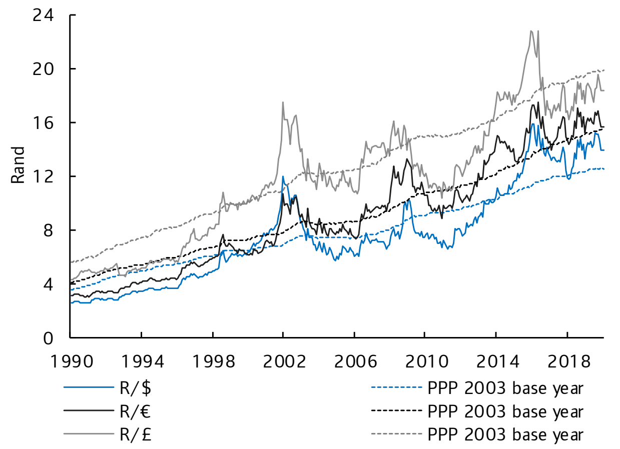
Assessments of the value of the rand differ across valuation metrics. Even purchasing power parity (PPP) assessments differ markedly across the major currencies – the rand seems to be strong relative to the pound, weak relative to the dollar and in line with its PPP estimate against the euro. We forecast the rand to be relatively stable against the dollar on average in 2020, apart from a downgrade-related spike, premised on the dollar weakness foreseen by our G10 strategist Steve Barrow. Against a stronger pound, though, the rand will likely lose more ground. We emphasise the real trade-weighted assessment, which arguably implies that the rand was on average reasonably valued in 2019.

Figure 24: Real trade-weighted rand implies rand is fairly to slightly overvalued



Source: SARB, Bloomberg, Standard Bank Research

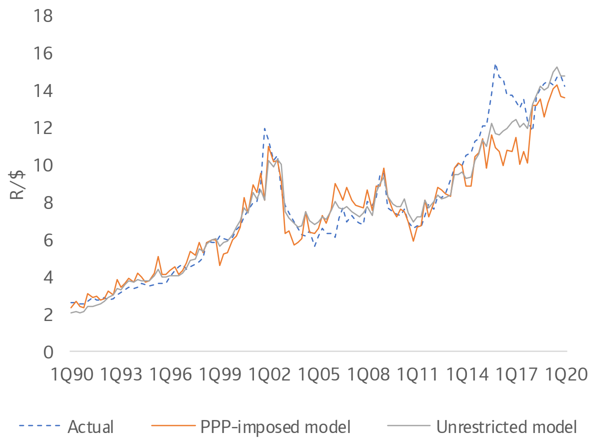
Figure 25: Rand weak vs USD PPP, around EUR PPP, strong vs GBP PPP



Source: Bloomberg, Standard Bank Research

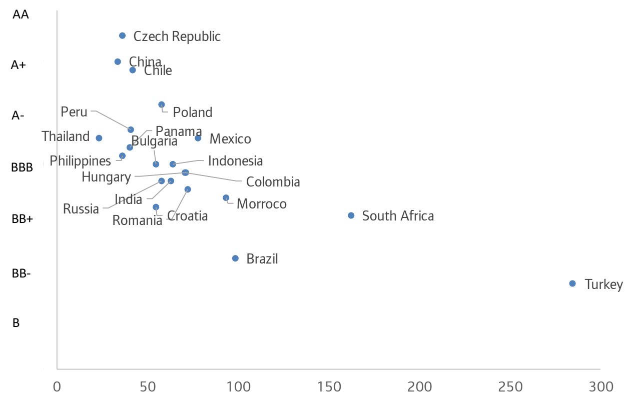
The rand is within the range of fair value estimates of our econometric models, which essentially compares the rand to the Australian dollar as a proxy for prevailing global commodity and currency markets, with appropriate adjustments for differences in the two economies' economic fundamentals. The rand's weakness relative to peers also seem reasonable given the weakness in SA fundamentals and when taking into account historical benchmarks. This is despite support from high real bond yields and elevated terms of trade.

Figure 26: Rand within fair value range estimated by econometric model



Source: Bloomberg, Standard Bank Research

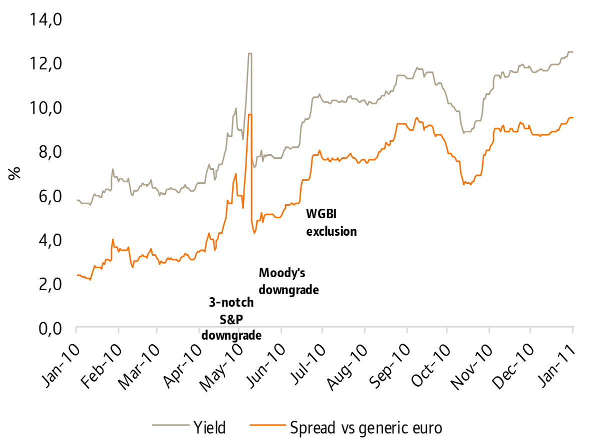
Figure 27: CDS vs sovereign credit ratings comparison suggests SA already priced like junk-rated country



Source: Bloomberg, Standard Bank Research

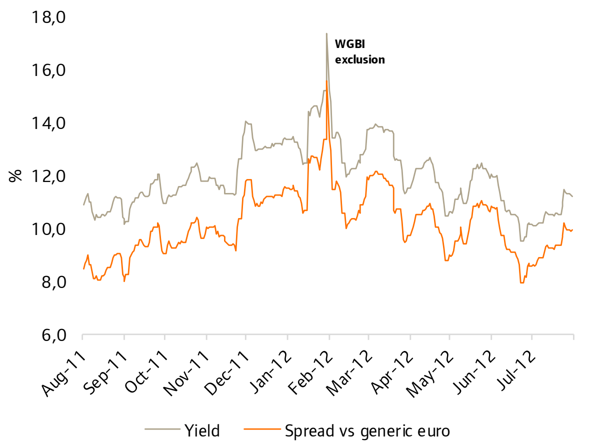
SA's expulsion from the WGBI, which will be triggered if Moody's downgrades SA, should only have a temporary impact on the currency and bond markets given the expected capital outflows that will follow. Sovereign credit ratings, according to our econometric analysis, do not (on average) influence the rand and local bonds beyond the underlying economic fundamentals that underpin them. Ultimately, the subsequent sustained levels depend on the trajectories of economic fundamentals and global market conditions. We pencil in a trend of modest nominal depreciation in the trade-weighted rand in the medium term from its 2019 average levels, with the real trade-weighted rand expected to essentially trend sideways.

Figure 28: Greek bond yields spiked when it lost its investment-grade status



Source: Bloomberg, Standard Bank Research

Figure 29: Portuguese bonds spiked when expelled from the WGBI



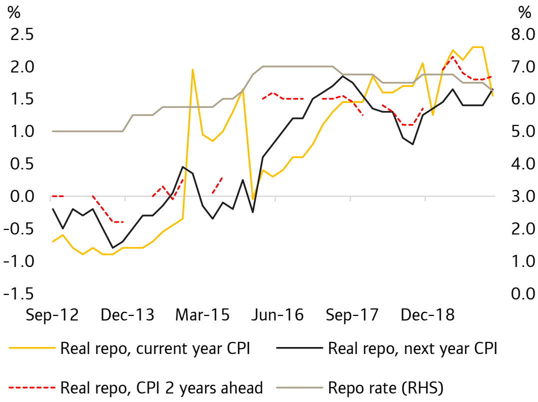
Source: Bloomberg, Standard Bank Research

Weak inflation may compel lower rates

We foresee only a marginal rise in inflation in 2020 after averaging less than the inflation-target mid-point in 2019. This is supported by low global inflation, weak domestic demand and the (expected) absence of sustainable rand weakness. Elevated agricultural grain prices should boost retail food inflation. However, despite unfavourable base effects and the below-average rainfall forecast for the upcoming maize planting season, these agricultural prices have remained reasonably tame (partly owing to rand strength) and there is limited pipeline pressure that still needs to filter through. For now, poor rainfall might underpin some culling, while the renewed outbreak of foot and mouth disease constrains exports, suppressing red meat prices in the near term (although these supply constraints will ultimately underpin upward price pressure). We thus expect a modest retail food inflation cycle in 2020, in addition to which we pencil in ongoing pressure from real electricity tariff increases, in line with the latest tariffs awarded by Nersa. We further assume normalisation of some of the categories that have recently been recording extremely low inflation, including the weighty rental inflation category, though we see the risks as definitively biased to the downside amid the demand weakness.

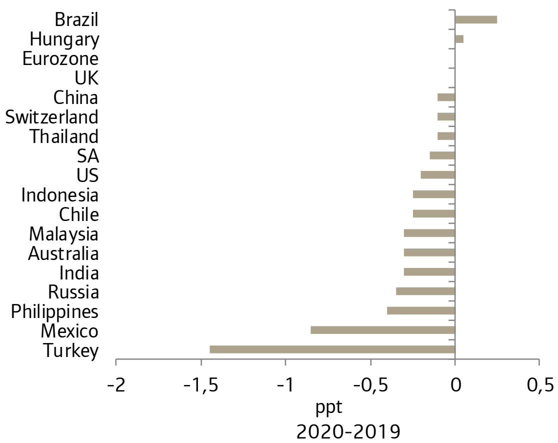
Not only are our inflation forecasts close to the mid-point of the inflation target and below the SARB's forecasts, but surveyed inflation expectations appear to be very well anchored inside the target range, while breakeven inflation is also endorsing the SARB's credibility in anchoring inflation around the middle of the target band. We thus concur with the money market's view that the SARB will cut rates by another 25bps this year.

Figure 30: Real rates still higher than SARB's recent interest rate cuts



Source: Bloomberg, Standard Bank Research

Figure 31: Policy rates generally expected to fall further in 2020

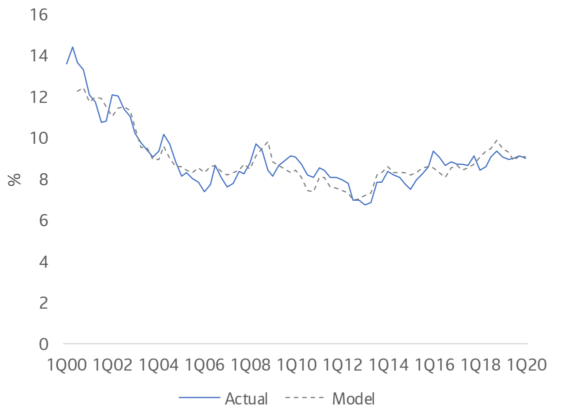


Source: Bloomberg, Standard Bank Research

Bonds cautious amid high risks

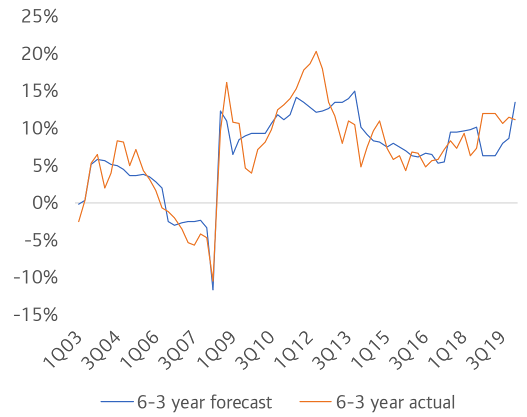
Our econometric model of the 10-year generic yield estimates that it is discounting a debt-GDP trajectory of around 77% (*ceteris paribus*, see Bond model: unpacking the drivers). In other words, bonds seem to adequately discount the weak fundamentals associated with the deterioration in SA's sovereign credit ratings as well as a sizeable risk premium. Local bonds, like the rand, might sell off in response to the WGBI expulsion, which could present a buying opportunity provided that government takes steps to restore fiscal sustainability, though we don't rule out the possibility that there is, from reasonably weak levels, no further bond weakness.

Figure 32: Econometric model of 10-year generic yield implies it discounts a debt-GDP trajectory around 77% or sizable risk premium if our 72% forecasts materialise



Source: Bloomberg, IRESS, Standard Bank Research

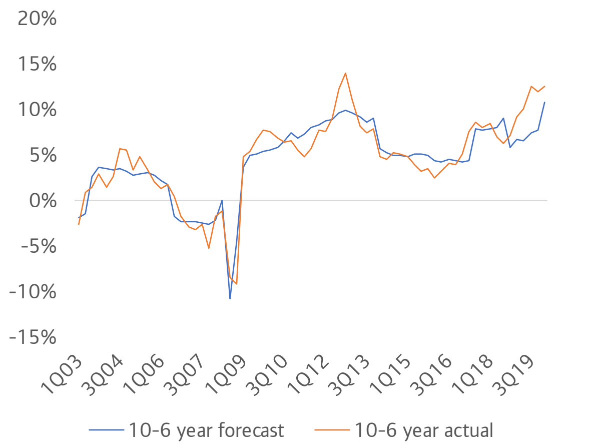
Figure 33: Adjusted 6-3 year yield spread[6] seems to be reasonable, discounting realistically weak fiscal trajectory



Source: Bloomberg, Standard Bank Research

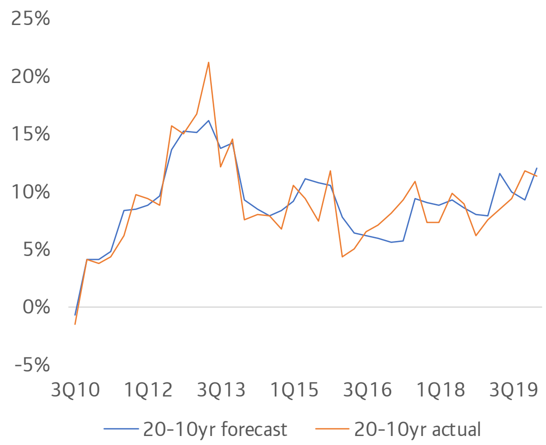
Following the sharp increase in local bond issuance in August 2019, government could theoretically delay increasing bond issuance after the 2020 Budget if it assumes that the pace of non-comp uptake persists and if its fiscal forecasts are similar to ours. However, we expect government's assumptions in this regard to be more conservative, as usual, in which case it could increase bond issuance by around R300 m per week, particularly given that funding requirements are not expected to decline in the future. While government only ruled out switch auctions in 2019/20, a resumption of these auctions is not really supported by the redemption profile, unless they are merely used to smooth increases in issuance, given that redemptions will rise in 2020 - 2021 but remain low relative to the subsequent (longer-term) trend.

Figure 34: Adjusted 10-6 year yield spread seems steep even for a severe fiscal scenario



Source: Treasury, Standard Bank Research

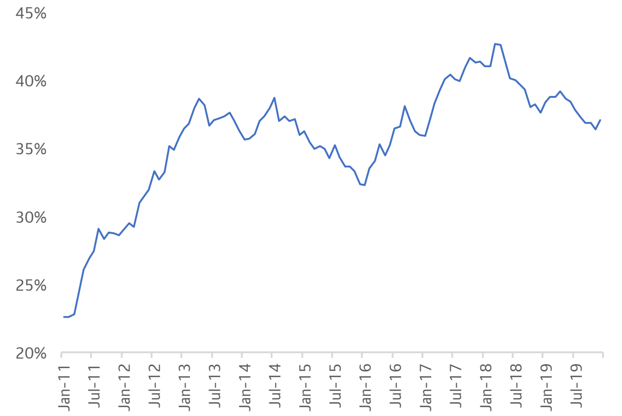
Figure 35: Adjusted 20-10 year spread flat, but 20-year steep vs shorter end once adjusted for 10-year steepness



Source: Treasury, Standard Bank Research

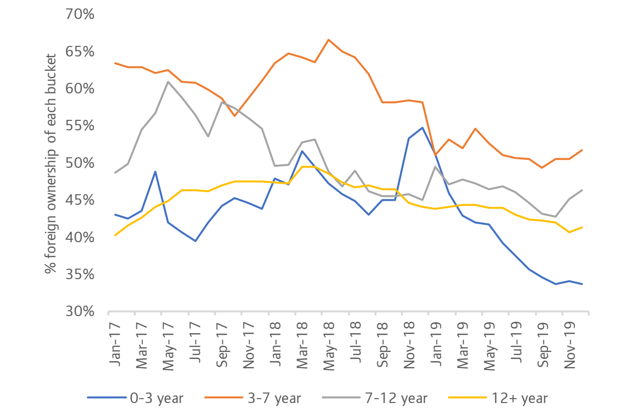
6 *Adjusted for the level of short-term rates.*

Figure 36: Foreigners bought bonds in December, increasing their ownership proportion …



Source: Treasury, Standard Bank Research

Figure 37: …they dislike short-dated bonds



Source: Treasury, Standard Bank Research

Figure 38: Forecast summary

% avg	2019	2020	2021
Household consumption expenditure (HCE)	1.1	1.2	1.6
Gross fixed capital formation (GFCF)	-0.4	0.5	1.6
GDP	0.3	0.8	1.5
Current account (% of GDP)	-3.2	-3.2	-3.4
R/$ (avg)	14.43	14.68	14.79
R/$ (YE)	14.00	14.60	14.90
R/€ (avg)	16.16	16.99	18.11
R/£ (avg)	18.37	20.41	22.39
CPI (avg)	4.1	4.4	4.6
Repo rate (YE)	6.50	6.00	6.00
10-year generic bond (YE)	9.0	8.8	8.7

Source: Bloomberg, Standard Bank Research

Elna Moolman[#]

See:
https://ws15.standardbank.co.za/ResearchPortal/Report?YYY2162_FISRqWkWXsiVvZ2Df6d6RWf8LkxGxAFu2In+h7ataAnzcyZhBSp7I8gA9/oWomgu/xoilTm+eZxFlsNR4ivNUQ==&a=-1

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