19 January 2022

South Africa in 2022

Growth risks, SARB hikes, but some fiscal reprieve

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- Energy shortages, record-high joblessness and tighter global financial conditions point to a sharp growth slowdown
- We expect above-target inflation and upside CPI risks to prompt 125bp of SARB hikes in 2022
- Surging tax receipts curb near-term budget risks, but high debt and spending pressures will keep fiscal challenges in focus

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South Africa's fourth wave of COVID-19 appears to be fading fast and its economic impact set to be much more modest than in the past, when acute pressure on the healthcare system prompted tighter lockdown restrictions and greater interruption to the functioning of the economy. Yet even as Omicron-related risks ease, the economic outlook remains troubled; we forecast GDP growth of 4.9% in 2021, falling to 1.7% in 2022.

Much of this reflects concern over the country's energy supply shortfall, evident in the significant shortages and load-shedding experienced last year, with few signs that the generation gap will be plugged over our forecast horizon even as policy interventions suggest new private sector energy projects could give a fillip to investment. Meanwhile, a dispiriting dynamic of continued job losses that has seen unemployment rise to 35% suggests that the consumer recovery could flag, depriving the economy of a key pillar of the rebound from 2020's lockdown lows.

Although growth may be slowing, CPI pressures are rising and global financial conditions are tightening, a combination that we think will prompt the SARB into 125bp of rate hikes this year and another 100bp in 2023. This would represent a measured pace of normalisation, but we believe the risk is tilted towards faster tightening amid upside inflation pressures from higher fuel and electricity costs, rising global producer and food price pressures, and a weaker ZAR. The SARB is likely to closely monitor inflation expectations for any signs that these are losing their anchor from the 4.5% mid-point of the target range.

Strong commodity prices mean the FY21/22 fiscal outlook has continued to improve and we now forecast a fiscal deficit equal to 4.9% of GDP in FY21/22. This would be roughly half the previous year's deficit, much lower than the government's current estimates. The near-term respite afforded by higher mining revenues and large cash buffers reduces our near-term fiscal concerns, but risks remain, principally around higher levels of government spending and elevated debt levels. This leaves us still cautious over South Africa's long-term fiscal prospects and reiterates the need for reforms that boost long-term growth, and address other sources of underlying macro risk.

This is an abridged version of a report by the same title published on 19-Jan-22. Please contact your HSBC representative or email AskResearch@hsbc.com for more information.

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Growth risks, SARB hikes but near-term fiscal reprieve

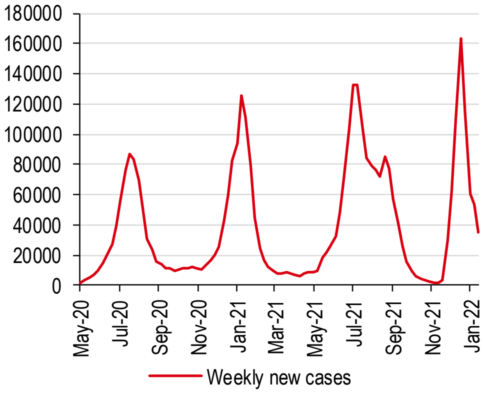
- Growth challenges remain significant amid energy shortages, record-high joblessness and tighter global financial conditions
- We expect the SARB to raise rates by 125bp this year in response to above-target inflation and upside CPI risks
- Surging tax receipts provide near-term relief from budget pressures, but spending risks leave long-term fiscal vulnerabilities undimmed

Guarded on growth

A myriad of growth headwinds – energy shortages, record-high joblessness, weakening terms of trade – point to an uncertain and challenging growth outlook, but the immediate threat posed by the fourth wave of COVID-19 appears to be fading. After a rapid rise in new cases following the detection of the Omicron variant in late November 2021, South Africa's latest wave of new infections has passed quickly (chart 1), suggesting that the country entered 2022 with the pandemic as a less severe headwind to the outlook than previously feared.

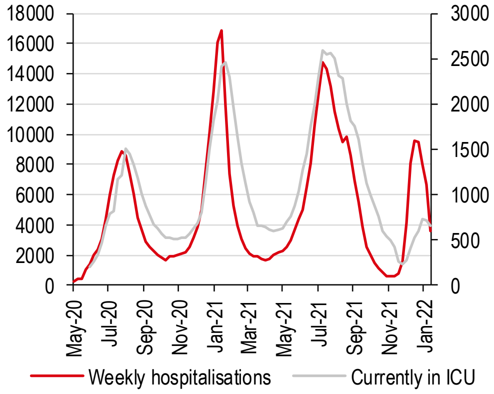
There has been much less pressure on the healthcare system than during previous waves, with fewer hospitalisations and patients admitted to intensive care (chart 2). As a result, the government did not tighten lockdown restrictions, supporting ongoing gains in consumer activity in recent weeks (chart 3).

1. The Omicron variant led to a sharp spike in new cases, but the peak has passed…



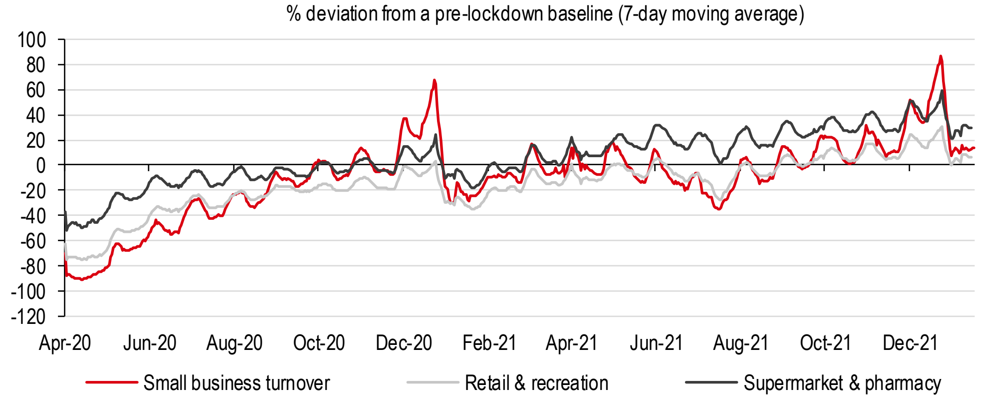
Source: NICD, HSBC

2. …with less pressure on the healthcare system, allowing the economy to stay open



Source: NICD, HSBC

3. Consumer activity appears to have picked up during H2 2021



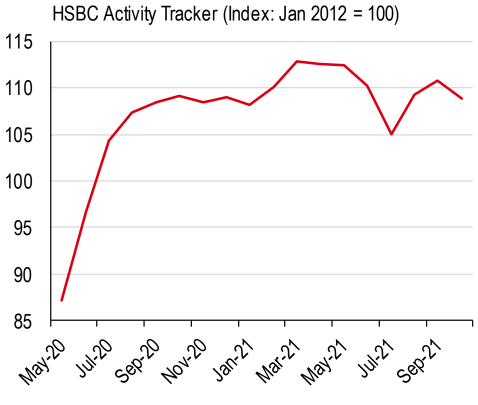
Source: Google Mobility, Yoco Small Business Monitor, HSBC

However, stricter cross-border travel curbs from other countries damaged the nascent tourism revival, and beyond this, low vaccination rates – only about one-third of South Africans are vaccinated – mean that future waves and variants of COVID-19 are an ongoing downside risk to growth prospects and the broader economic outlook.

The signs of consumer spending gains suggest a relatively robust end to last year, but follow a period of sluggish and volatile growth, whereby the reopening rebound from the lockdown lows of Q2 2020 was punctured by a series of disruptions. These included losses from July's social unrest, the protracted third wave of COVID-19 and tighter lockdown restrictions imposed, energy shortages that prompted renewed power cuts from the state-owned energy company Eskom, and a prolonged manufacturing strike in October.

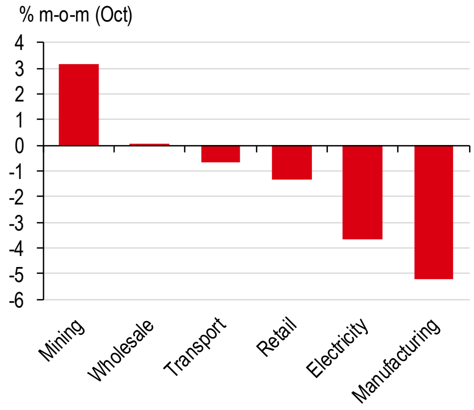
The economy contracted by 1.5% q-o-q in Q3 2021, reversing many of the gains from the first half of the year, while industrial action across the metals and engineering sectors and power cuts help to explain why our tracker contracted by 1.5% m-o-m amid the sharp fall in manufacturing and electricity production (charts 4 and 5). In response to these headwinds we recently pared our 2021 growth estimates slightly, and now forecast GDP growth of 2.0% q-o-q in the fourth quarter and 4.9% for the year as a whole. The latest high frequency data suggest the risks may be skewed towards softer Q4 growth.

4. The HSBC activity tracker contracted by 1.5% m-o-m in October 2021…



Source: Statistics South Africa, HSBC

5. …as industrial action and outages cut manufacturing and electricity production



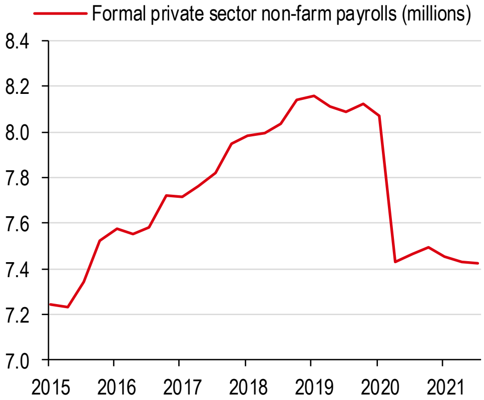
Source: Statistics South Africa, HSBC

The ongoing labour market fallout

The labour market remains the clearest marker of the economic dislocation from the pandemic shock. Jobs continue to be lost, with the latest payroll data showing that formal private sector non-farm employment is below Q2 2020 lockdown lows and 8.6% down on pre-pandemic levels (chart 6). Unemployment rose to c35% in Q3 2021, and is highest for the young, less educated, women, and the Black/African population group. Youth joblessness was 66.5% (chart 7), and 6m of the unemployed have not worked for a year or longer. This rise in long-term unemployment may result in de-skilling, impede future job prospects, and threatens a more lasting headwind to potential growth as employment levels decline, exacerbating the pre-existing low level of labour utilisation.[1]

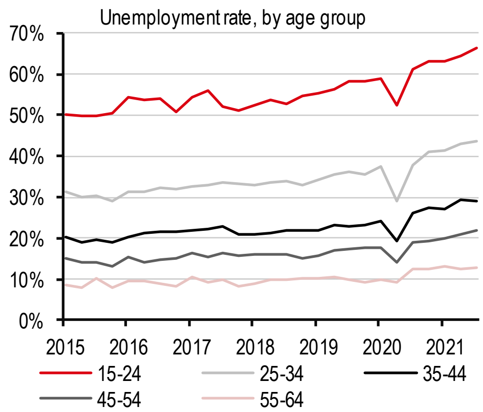
As a result, there are currently many more people unemployed in South Africa than in the United States (where the labour force is more than seven times bigger) while IMF data shows that the unemployment rate is not only the highest in the world, but also about five times higher than the median. Reversing these losses will take a considerable time, and while we think it's possible the economy may recoup the GDP losses by the middle of 2022, South Africa's labour market scars are far deeper and will take much longer to heal.

6. Private sector non-farm formal jobs are now below the lockdown lows of 2Q20…



Source: Statistics South Africa, HSBC

7. ...and youth unemployment has risen to 66.5%



Source: Statistics South Africa, HSBC

A constrained consumer

The ongoing labour market shock presents a key headwind for the economic outlook, shackling incomes and consumer spending prospects in the near term. A recovery in tourism and construction related to new energy generation projects likely present the greatest opportunity for job gains this year, with employment levels in these sectors 20% or more below pre-pandemic levels.[2] However, we assume that employment will rise only slowly from its lows, while higher inflation, SARB rate hikes, weak confidence, and the soft pace of household credit growth are also likely to erode real income gains and temper the pace of consumer spending. All told, we expect real household consumption to grow by 1.8% in 2022 and 1.7% in 2023, significantly slower than our estimate for last year of 5.7% but broadly in line with the pace of household spending before the pandemic (2013-2019: 1.5%).

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[1] Low labour utilisation has dampened the economy's growth capacity and undermined the potential for a demographic dividend, whereby a growing working age population boosts the supply of labour and its productive potential.

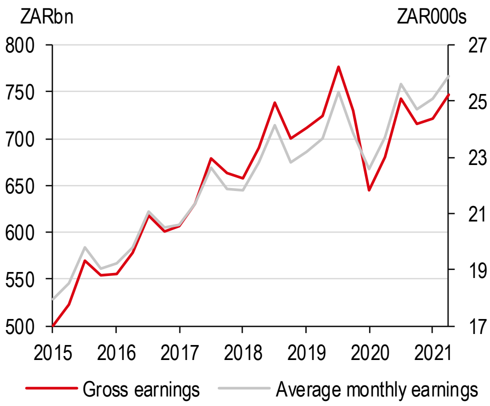
[2] Formal employment in hotels and restaurants is 22.6% down on 2019 levels (-74k jobs), while there are 19.6% fewer formal sector construction jobs (-117k). Other sectors where employment remains significantly below pre-pandemic levels include manufacturing (-10.4%/-126k), other business services (-9.8%/-104k)). Just eight of the 90 sub-sectors details in the Quarterly Employment Statistics (QES) data are at or above pre-pandemic levels, with these primarily covering mining and the government.

These views may prove too downbeat. Indeed, the pace of wage gains and earnings growth last year surprised to the upside, with strong wage gains for those that retained their jobs ensuring that economy-wide earnings increased at double-digit pace in Q2 and Q3, recovering the losses from the pandemic despite the lack of job creation (chart 8). Some of this is likely to reflect the normalisation of pay following last year's lockdown, but there have also been some bigger pay increases in the public and private sector.[3] Looking ahead, we think average wages will grow by c4.5% this year, restrained by the slack in the labour market and fiscal constraints, but acknowledge that this may be tested by higher inflation, and amid signs of some higher wage outcomes recently.

In addition to the public sector wage dynamics, consumer spending power will also be sensitive to fiscal developments around social grants. The decision to extend the social relief of distress (SRD) grant – effectively an unemployment grant of ZAR350 per month – following July's civil unrest gave a fillip for household incomes and spending in the lower half of the income distribution by boosting social grants by ZAR27bn (c0.4% of GDPe).

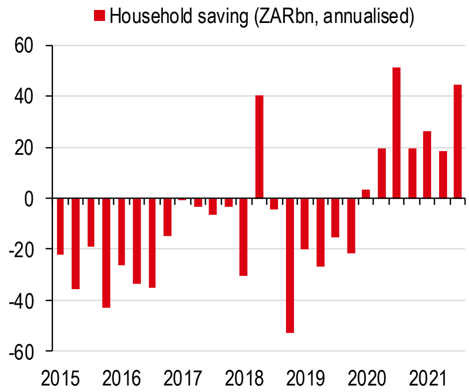
We expect the upcoming 2022 Budget in February to extend the current level of income support. A more generous SRD grant, as the government seeks to reduce the share of the population living below the food poverty line, would provide upside to the consumer outlook, while adding to fiscal risks. On the margin, household spending may also receive support from the accumulation of household savings over the past 18 months that have averaged 0.8% of disposable income (chart 9).

8. Gross earnings have recovered on the rebound in average monthly pay



Source: Statistics South Africa, HSBC

9. Households continued to save during 2021



Source: SARB, HSBC

The outlook for government spending is more subdued over our forecast, given the proposed fiscal consolidation outlined in the Medium Term Budget Policy Statement (MTBPS). Indeed, the national treasury estimates that real government consumption will contract by more than 2% per year on average over 2022-23. We incorporate higher levels of social grant spending and a bigger increase in public sector wages in our numbers but still see real government consumption contracting by 0.5% per year over 2022-23.

[3] The government estimates that the public sector wage bill will increase by 4.8% in FY21/22 after the 2021 Budget targeted a wage freeze, the pay deal in the metals and engineering sector following a protracted strike will see wages rise by 5-6% per year, while a wage agreement at one of the country's gold miners will see wages rise by almost 7.5% per year over the next two years.

Investment gains

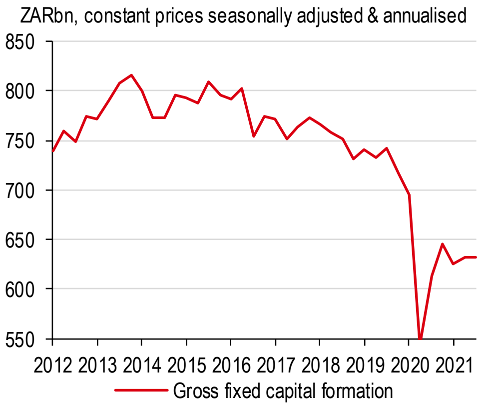
We are more upbeat on investment spending in 2022, and see this year as marking some reversal of the long-term decline in fixed capital formation, which has left investment more than 20% below its peak from Q4 2013 (chart 10). The primary source of weakness has been a sharp decline in public sector investment as capital spending by state-owned enterprises more than halved and government investment declined by almost 20% (chart 11). However, private sector fixed capital formation has also been weak and is still down 15% on pre-pandemic levels.

Much of the weakness in private sector investment over the past decade aligns with low levels of business confidence and energy shortages. And while there has been some improvement in business confidence following the record low in Q2 2020, sentiment levels remain below the 50-level, indicating that the majority of firms surveyed remain dissatisfied about prevailing conditions and suggesting that confidence is too low to drive a broader gain in private fixed capital spending. The outlook for public investment may also be weak, with ongoing financial pressure and balance sheet strains likely to crimp infrastructure spending by the public sector.

However, despite these headwinds we see some upside for investment from the plethora of new private sector energy projects as the government seeks to boost generation capacity and deliver a more stable power supply. These include projects that form part of the country's risk mitigation power procurement round (2,000MW), the latest bid window for renewable IPP projects (2,600MW), and last year's energy sector reform that lifted the licensing requirement for self-generation projects from 1MW to 100MW.[4] Together, these interventions could ultimately add 10,000MW of new (primarily renewable) capacity to the grid, with investments from the risk mitigation and latest renewable IPP round split evenly between South African and offshore companies.

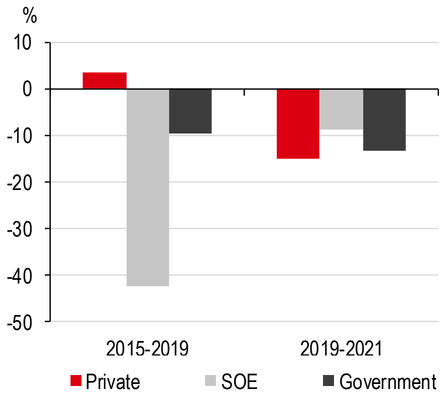
Much of the construction is likely to take place over our forecast horizon, but given long lead-in time many projects may only start connecting to the grid from 2023 onwards, suggesting an ongoing energy supply shortfall. Nevertheless, the boost to investment could be substantial with estimates totalling more than ZAR150bn, which would be equal to almost 20% of investment spending over the past 12 months.[5]

10. Investment has struggled to gain and is down 14% on pre-pandemic levels…



Source: Statistics South Africa, HSBC

11. …with the long-term decline led by lower public sector capital formation



Source: Statistics South Africa, HSBC

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[4] The minerals council estimates that its members will look to build 3,900MW of generation capacity following the embedded generation reform, while earlier estimates using a 50MW limit estimated a total of 5,000MW being built over five years.
[5] The government has indicated that the emergency power procurement round will inject ZAR45bn of private sector investment, that Bid Window 5 of the REIPPP programme will stimulate ZAR50bn in private fixed capital formation, while the Minerals Council estimates that mining companies could invest ZAR60bn in energy projects.

Macro risks from energy shortages and commodity prices

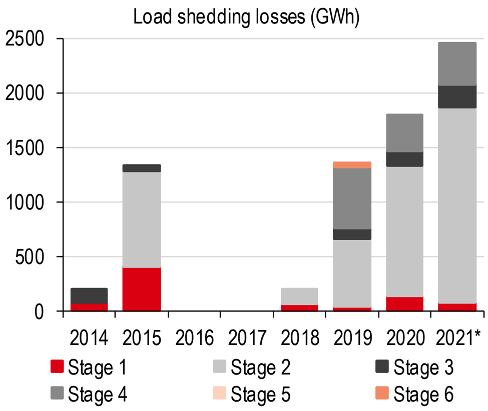
Energy supply shortfall and a low ceiling for growth

In the end, while we see such investment in energy projects as a key driver for growth over our forecast horizon, we still believe there will not be sufficient investment to overcome the 4,000-6,000MW generation capacity gap that leaves South Africa vulnerable to energy shortages and load-shedding (scheduled power outages rotated around the grid to manage demand lower).

Load losses from power outages totalled almost 1,200 hours and about 2,500 GWh in 2021 (chart 12), a marked increase on previous levels as unplanned outages left one-quarter of Eskom's power stations unable to produce power and cut energy availability – the share of Eskom's installed capacity that is producing electricity – to just 61% last year (chart 13).

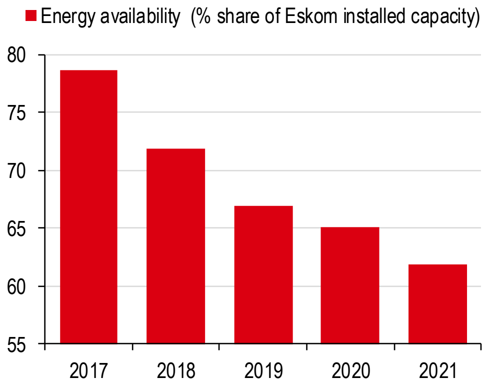
With energy availability deteriorating on higher unplanned outages, and new projects likely to take time to relieve pressure on existing supply, the energy constraint will inevitably play an influential role on South Africa's growth outlook. Indeed, we see the energy constraint as imposing the low ceiling on growth over the next two years precluding faster growth.

12. Load shedding losses increased by c30% in 2021…



* 2021 shows data for January to November
Source: CSIR, HSBC

13. …while energy availability fell to 61% of installed capacity



Source: Eskom, HSBC

Although the energy constraint offers the primary risk for growth, we think a bigger risk for the macro balances is a reversal in commodity prices. The surge in export commodity earnings (chart 14), primarily driven by PGMs (mainly rhodium) and iron ore, over the past 18 months has underpinned significant terms of trade gains (chart 15) and surging exports, and provided a windfall for tax receipts following the boost to mining sector profits.

Exports of key commodities were up by 34% y-o-y in 2021 and were 66% higher when compared with 2019 (chart 16).[6] Yet commodity prices have fallen c30% from their peak in May 2021, a move that has been led by PGMs and that is likely to both dampen export performance in the coming quarters and weigh on mining sector profits and tax receipts over FY22/23 and beyond.

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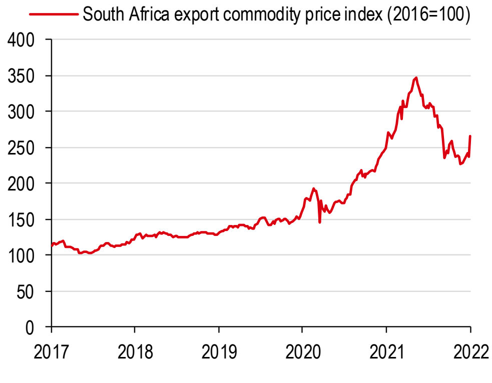
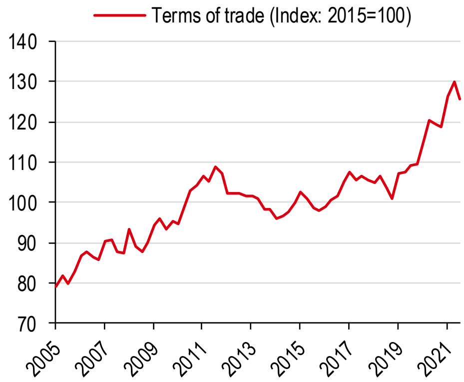
[6] Rhodium exports have risen by 150% and account for almost half of the export gains in 2021. Other key contributors have been iron ore, palladium, platinum and coal, whose growth has ranged from 27% y-o-y to 38% y-o-y.

14. South Africa's commodity prices have faded from their highs…



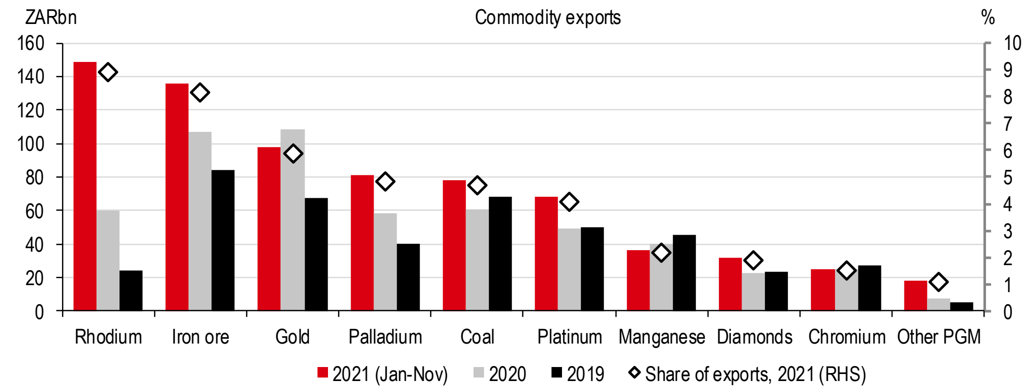
Note: The index uses prices of PGMs (platinum, palladium, rhodium), gold, iron ore, coal, manganese and chromium weighted by a 4QMA of export shares.
Source: Bloomberg, HSBC

15. ...but the strong rise since late 2018 has pushed up the terms of trade



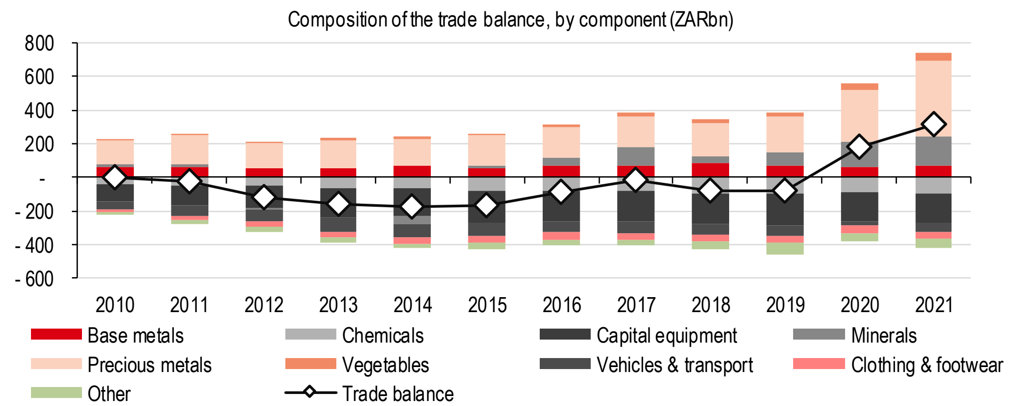
Source: SARB, HSBC

16. Surging PGM and iron ore prices have given the biggest impetus for export gains…



Source: Department of Trade, Industry, and Competition, HSBC calculations

17. ...and evident in the role of commodities driving the improved trade balance



Source: South African Revenue Service, HSBC calculations

Higher oil imports as a result of rising prices and stronger non-oil imports, particularly machinery and equipment, in response to higher levels of import-intensive investment spending in the energy sector, are also likely to reduce the size of the trade surplus. Alongside an ongoing services deficit following Omicron and a delayed tourism revival, and structural deficits in terms of the income account and net current transfers, we think this works to narrow the exceptional external gains seen over the past 18 months, eventually pushing the current account back into deficit this year and making the economy reliant on capital inflows.

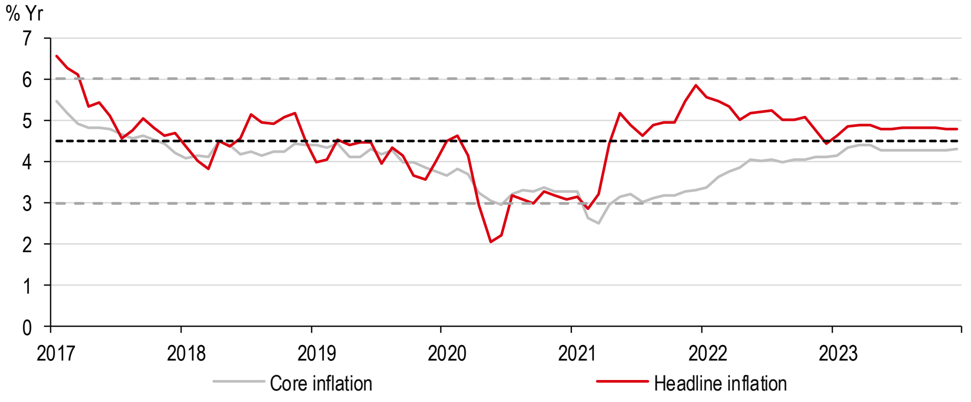
Inflation and the SARB

Trending above target

As has been the case globally, South Africa's growth-inflation mix has deteriorated, with inflation picking up pace and rising towards the upper band of the SARB's 3-6% inflation target range. We think the peak in inflation took place at the end of last year, and we are likely to see some disinflation in the coming months, but price pressures are pointing towards inflation trending above the 4.5% mid-point of the range targeted by the SARB for the majority of our forecast horizon. We forecast headline inflation to average 5.1% this year and 4.8% in 2023 (chart 18).

Inflation has been pushed higher by supply-side factors. Fuel inflation likely reached 40% y-o-y in December and averaged c19% in 2021, electricity tariffs rose by 14% in the second half of last year, and food inflation topped 7% y-o-y during the third quarter. Base effects should help to take the annual rate of fuel inflation lower through the course of 2022 even as the fuel price tracks sideways in response to elevated oil prices and a weaker ZAR (chart 19). At current oil prices, however, fuel inflation is likely to put additional pressure on CPI given our underlying assumption of USD75/b over our 2022-23 forecast horizon.

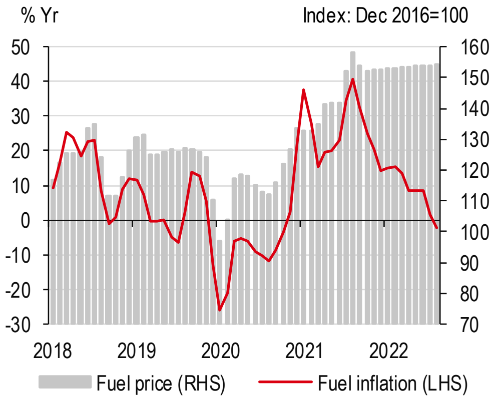
18. We think inflation peaked at the end of 2021, and will average 5.1% this year



Source: Statistics South Africa, HSBC estimates from Dec 2021

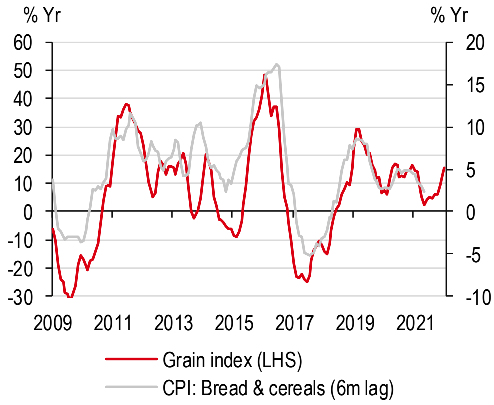
There has already been some relief for food inflation, which eased to 6% in November 2021 as bread and cereals, meat, and vegetable inflation softened, and we think moderating meat price pressures could help food inflation to ease further in the coming months. However, we see food inflation starting to rise again from the end of Q2, with the risks skewed towards higher price growth amid the pick-up in grain prices (chart 20), higher input costs, elevated global prices and producer inflation, and most recently flood damage to key crop producing areas of the country.

19. Fuel inflation should fade on base effects



Source: Statistics South Africa, Central Energy Fund, HSBC estimates from Dec 2021

20. Grain prices have risen in recent months



Source: Bloomberg, Statistics South Africa, HSBC

Finally, electricity tariffs are likely to stay high, with Eskom seeking a 20.5% rise for 2022/23. The final increase could potentially be even higher depending on how Eskom is able to recover past costs not accommodated for in previous tariff decisions.[7] The final outcome will reflect the decision from the national energy regulator (NERSA), which is due by 25 February.

Core contained

Core inflation by contrast stayed subdued throughout 2021, averaging just 3.1% y-o-y. This is slightly below its average in 2020, supported by the marked disinflation in medical insurance, very low rental inflation, and lower increases in primary schooling fees that together pulled services inflation to a 15-year low of less than 3% y-o-y (chart 21). Lower inflation for these categories offset a rise in inflation for vehicles, alcohol and tobacco products, and other core goods and services. But we think 2021 was the low, and that core inflation will steadily move higher on higher insurance premiums, a gradual rise in rentals inflation, and as a weakening ZAR puts upward pressure on imported goods.

The upcoming reweighting of the CPI basket, which will take place from the January 2022 CPI release to be published in February adds some degree of uncertainty to the CPI outlook. However, a cursory look at household spending figures suggests relatively minor changes in consumption shares in recent years, with the biggest increase for miscellaneous services, which covers insurance, financial services, and other services, spending on fuel products, and smaller increases for household services (including domestic worker wages), medical services, recreation, entertainment and education, and medical and pharmaceutical products.[8] These increases have come primarily at the expense of a lower consumption share for transport and communication services, with smaller declines for food and beverages, clothing and footwear, motor vehicles, parts and accessories, housing (rent) and utilities.

While these changes may have some influence on the composition and level of inflation, we think risks to the inflation outlook remain firmly skewed to the upside. These include concerns over the broadening and acceleration in PPI inflation (chart 22), a weaker ZAR, and risks that oil prices, electricity tariffs, and food inflation could outpace our underlying assumptions. We think core inflation, by contrast is likely to remain relatively benign and contained below the 4.5% mid-point of the SARB's target range, assisted by services price growth that stays subdued.

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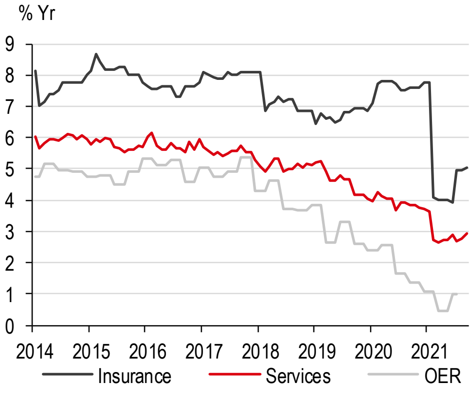
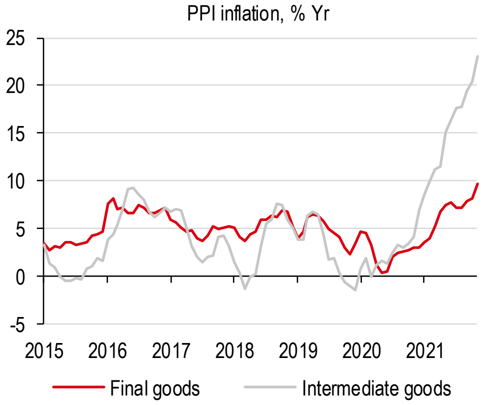
[7] Eskom's successful court challenge to the fourth multi-year price determination by the energy regulator could see ZAR23bn added to Eskom's revenue recovery in 2022/23 and 2023/24, adding c8-10% to electricity prices per year.
[8] Without a recent household expenditure survey, the statistics authority has used changes in the detail of household final consumption expenditure from the national accounts between 2017 and 2019.

21. Services inflation fell to a 15-year low in 2021 but is starting to move higher



Source: Statistics South Africa, HSBC

22. Producer price pressures have become increasingly broad-based and more acute



Source: Statistics South Africa, HSBC

SARB normalisation and the risks for quicker hikes

Our concerns over upside inflation pressures echo many of the short and long-term risks outlined in recent South African Reserve Bank (SARB) monetary policy statements. The SARB increased the policy rate by 25bp to 3.75% following its November MPC meeting[9]. It was a split decision, but with the economic disruption from Omicron looking likely to be limited, inflation risks rising, and the Fed set to deliver faster tapering and tightening than previously anticipated, we see a high likelihood of sustained tightening cycle ahead. This will likely see rates rise by a total of 125bp of rate hikes in 2022 starting with a 25bp hike in January (chart 23). In raising the policy rate to 5.00% by the end of this year and 6.00% at the end of 2023, the SARB would take the real policy rate back into positive territory, and close to its terminal level, in our view.

Our forecast is broadly aligned with the SARB's current quarterly projection model (QPM) that guides towards 135bp of rate hikes in 2022, but projects more tightening than the current Bloomberg consensus. Market pricing using forward rate agreements, however, is more hawkish still, pricing more than 200bp of SARB rate hikes over the next 12 months. At this stage, however, we think subdued core inflation, contained inflation expectations (chart 24), record-high unemployment, and differences in views within the MPC over the appropriate pace of tightening (with signs of this implicit in the divided November vote), will result in the MPC adopting a gradual approach to tightening that stays sensitive to the sluggish growth recovery.[10]

Nevertheless, the risks appear skewed towards more front-loaded SARB tightening, which would be more likely if there is a more aggressive path of policy tightening from the Fed. Upside inflation pressures that take CPI further away from the 4.5% mid-point on a sustained basis, or a deterioration in inflation expectations, might also force SARB's hand.

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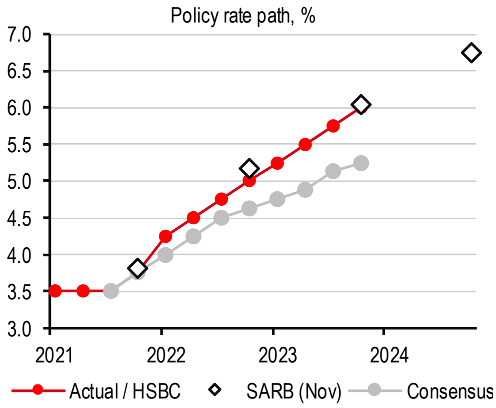
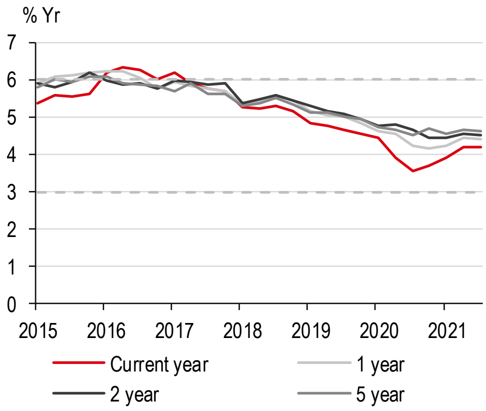
[9] Upside risks to the SARB's inflation projections are focused on rising global producer price and food price inflation, oil prices, and higher electricity tariffs and other administered prices in the short term and include a weaker ZAR, higher domestic import tariffs, and escalating wage demands over the longer term.
[10] We think that the SARB's QPM could price in more near-term tightening in upcoming MPC meetings if the SARB's CPI forecasts shift higher.

23. We see 125bp of rate hikes this year and 100bp of tightening in 2023



Source: SARB, Bloomberg, HSBC estimates from Jan 2022

24. Inflation expectations were well-contained last year even as inflation rose



Source: Bureau for Economic Research, HSBC

Fiscal: Relief for now, long-term vulnerabilities undimmed

Commodity revenue boost and rapidly rising tax receipts

While we expect SARB tightening in response to a deteriorating inflation outlook, our FY21/22 fiscal forecasts continue to improve as monthly budget and financing figures point to sustained tax gains and a narrower deficit (chart 25). The latest financing figures, for example, suggest a budget surplus of cZAR40bn in December 2021 and cash buffers back above ZAR350bn (c6% of GDP). If correct, these imply very strong corporate tax receipts, and point to a significantly smaller shortfall than the official projections, and reduced near-term financing pressures.[11]

We forecast a fiscal deficit equal to 4.9% of GDP in FY21/22, which would mark a halving in the deficit from a year earlier, and be much lower than the government's current estimate of 6.6% of GDP from the Medium Term Budget Policy Statement (MTBPS) in October (chart 26). In nominal terms, the deficit would be cZAR100bn smaller than current official estimates.

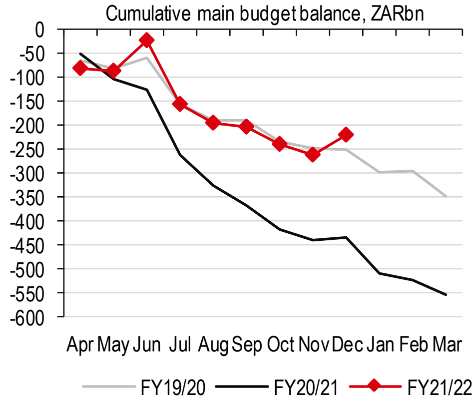
The smaller deficit primarily reflects further strong gains in tax revenues, which have risen by more than 30% so far this year, underpinned by a doubling in corporate tax collections, a sharp jump in excise duties and other tax revenues that were most affected by last year's lockdown restrictions and tax relief, and robust gains across other major tax streams including value-added tax (VAT), personal income tax (PIT) and the fuel levy (charts 27 and 28).

The strength of corporate income tax receipts is likely to reflect exceptional mining profits following the surge in South Africa's export commodity prices and terms of trade, while VAT gains mirror the strong rise in consumer spending. The most unexpected gains, in our view, are for personal income tax, which has risen 16% y-o-y to above pre-pandemic levels despite the labour market shock and lower employment levels.

We forecast tax receipts to have risen by more than 25% y-o-y in FY21/22, up by ZAR340bn (5.3% of GDP) on a year earlier, and equal to more than 25% of GDP, well above pre-pandemic averages and highlighting the boost from commodities.

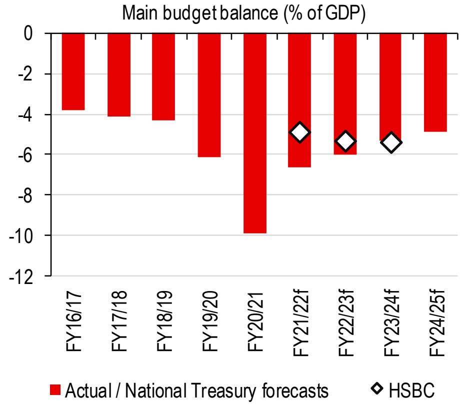
[11] Details of revenue and expenditure during December will only be published at the end of January.

25. The latest data suggest a smaller budget shortfall in FY21/22…



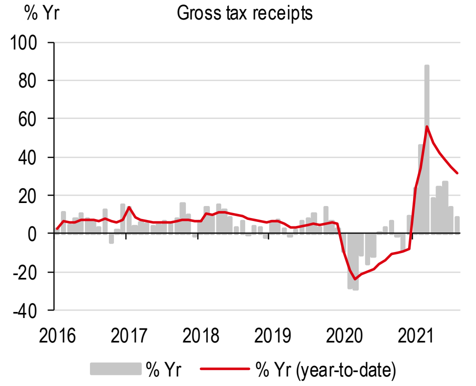
Source: National Treasury, HSBC calculations

26. …but we see medium-term fiscal consolidation stalling



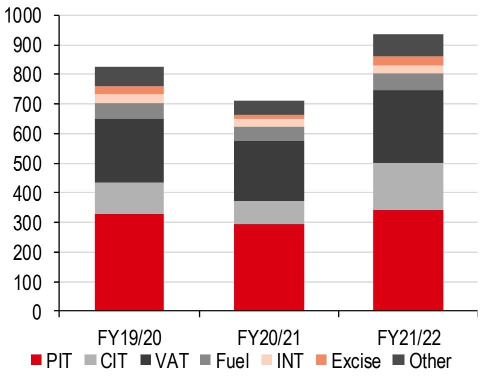
Source: National Treasury, HSBC estimates

27. Gross tax receipts have risen by more than 30% y-o-y…



Source: National Treasury, HSBC calculations

28. …with the biggest gains for corporate tax receipts



Source: National Treasury, HSBC calculations

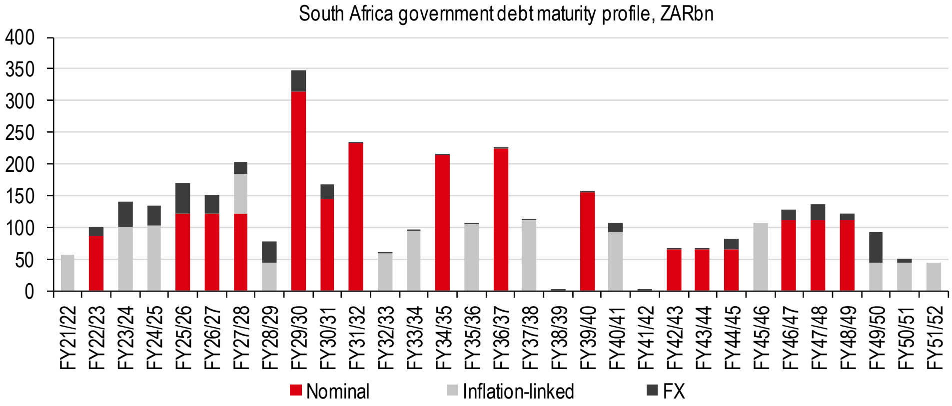
Some of this revenue gain has, however, been spent with the government's expenditure plans moving progressively higher through the course of FY21/22, and non-interest spending ZAR95bn higher than laid out in earlier estimates. Much of this reflects additional social grant spending following the extension of the social relief of distress (SRD) grant in August, a bigger-than-budgeted public sector pay deal, and capital injections into the state insurance company to cover losses incurred during the social unrest in July 2021.

Smaller deficit, bigger cash buffers

Despite spending ratcheting higher, stronger tax receipts is the dominant near-term fiscal theme, narrowing the budget shortfall and giving a boost to the government's cash buffers. Indeed, assuming the government delivers on the funding plan set out in the MTBPS, which includes USD5.3bn of external borrowing in FY21/22, the government will need to utilise far less of its large cash balances than current estimates to fund the deficit.

Indeed, based on our estimates, cash balances could sit at about cZAR340bn at the end of FY21/22, relieving funding pressures and suggesting the risks are tilted towards a near-term reduction in SAGB weekly supply in FY22/23. In our view, any decision on issuance will likely depend on the extent to which the government can credibly commit to its existing spending plans, and the prospects for switching shorter-dated maturing debt for longer dated bonds with a redemption profile that has cZAR290bn of local currency debt and cZAR85bn of external debt maturing over the next three fiscal years (chart 29).

29. There is cZAR375bn of debt maturing in the next three years



Source: National Treasury, SARB, HSBC calculations

Fiscal fragility – structural spending pressures

The near-term respite afforded by high commodity prices, surging tax receipts, and large cash buffers assuages our near-term fiscal concerns. But there is still a range of risks, principally around higher levels of government expenditure, that leaves us cautious over South Africa's fiscal prospects and the longer term outlook for the public finances. Indeed, we think that near-term fiscal relief could give way to a relaxation of the budget constraint and structurally higher levels of government spending. There is no shortage of spending demands, although we see higher levels of social grants, government wages, SOE bailouts, and pressures for higher health and education spending as the clearest adding c1.3% of GDP more to expenditure in our fiscal framework and forecasts than in the state's current estimates.

There are signs of broadening support behind the introduction of a more permanent form of basic income support to combat the pressures that derive from acute levels of unemployment and poverty, with the president highlighting the need for income support in a recent ANC address.

> **There is a clear need for some form of income support for unemployed and poor South Africans based on clear principles of affordability and sustainability**
>
> **President Cyril Ramaphosa, 8 January 2022 Statement**

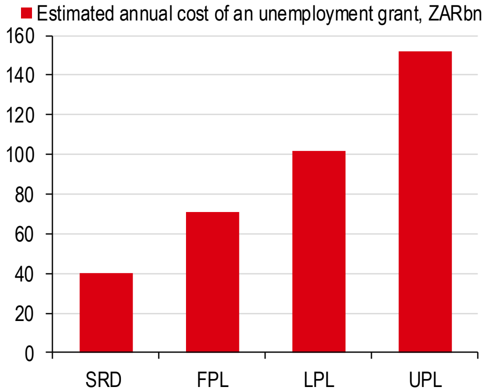
This may make it difficult to withdraw the ZAR350 monthly SRD grant, which, if incorporated in the fiscal framework in its current format, could add ZAR40bn annually to government expenditure, rising to ZAR70bn if a food poverty line (FPL) were to be used as a benchmark, and ZAR150bn at the national upper poverty line (UPL) (chart 30).[12]

The MTBPS indicated that "the budget will set aside additional resources for social relief if the fiscal situation improves by February 2022", arguing that to avoid a worsening budget deficit, this would be funded out of improved revenue performance, or via reprioritising and reviewing existing spending programmes. In our view, this sets the platform for extending the SRD grant into FY22/23 given the improvement in the revenue and funding backdrop.

[12] This assumes an estimated 9.5m recipients. The food poverty line in South Africa was set at ZAR624 per month in 2021. At the lower poverty line of ZAR890 per month, the cost would rise to ZAR100bn, and at the upper poverty line of ZAR1335 per month it would be as high as ZAR150bn.

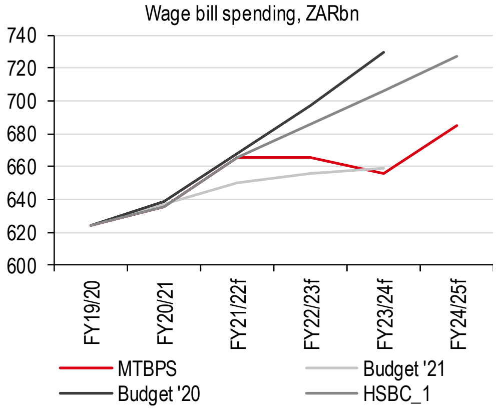
Government wages, meanwhile, account for more than two-fifths of non-interest spending, meaning that the government's medium-term budget consolidation ambitions rely on controlling public sector pay. The MTBPS projects government wages to fall marginally over the next two years then rise in line with inflation in the outer year, FY24/25, but the sensitivity of spending to this assumed path is significant. For example, a 3% annual rise in wages would add ZAR113bn to non-interest spending over the next three years, while a CPI adjustment (i.e. 4.5% per year) could add cZAR175bn (chart 31). In addition to these wage bill risks going forward, there is the ongoing risk that the government's decision to renege on the final year of the 2018 wage deal and freeze government pay in FY20/21 is overturned by the constitutional court.[13]

30. Additional spending on social grants could slow the pace of consolidation…



Note: SRD = social relief of distress grant (ZAR350), FPL = food poverty line (ZAR624), LPL = lower poverty line (ZAR890), UPL = upper poverty line (ZAR1335)
Source: HSBC estimates

31. …and any slippage on wage control could have significant effects on spending



Note: HSBC_1 shows a 3% annual rise in the government wage bill
Source: National Treasury, HSBC estimates

We also see upside spending pressures around the government's ongoing exposure to SOE risks via government guarantees that totalled almost ZAR600bn in FY20/21 (10% of GDP), with guarantees primarily extended to Eskom, Independent Power Producers (IPP), and the national roads agency, SANRAL. The government has allocated just ZAR78bn for payments to financial assets, which primarily reflect bailouts and fiscal support for the country's state-owned companies, with the majority going to Eskom, the state-owned energy company (ZAR66bn over three years). This would be a marked decline relative to recent years that have seen a sharp rise in SOE bailouts, with the financial and balance sheet strains at a range of SOEs suggesting bigger bailouts remains an underlying spending risk. Moreover, the budget does not provide for any form of debt relief for Eskom, with the power utility consistently arguing that it needs a ZAR200bn reduction in debt that could result in a 3-4% of GDP increase in sovereign debt. Other potential fiscal risks that the Treasury highlighted in the MTBPS include the weakened financial positions of sub-national government, and unfunded policy priorities such as National Health Insurance (NHI).

Long-term fiscal vulnerabilities

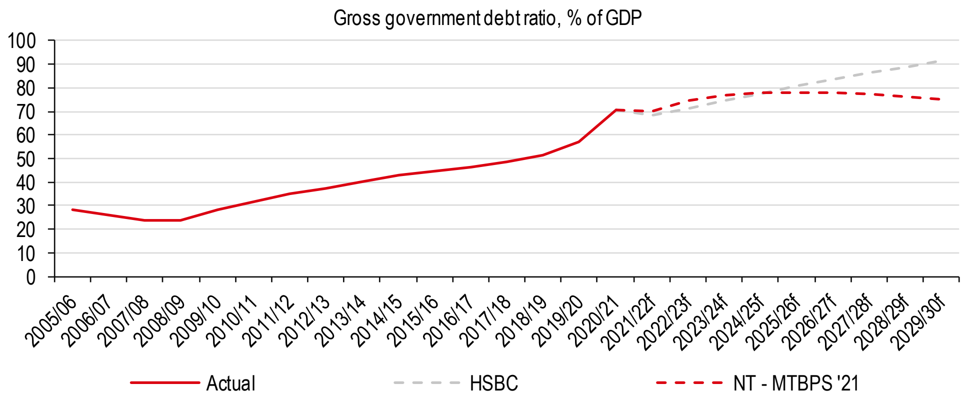
Boosted by the FY21/22 tax windfall, the government is in a position to chart a faster pace of fiscal consolidation, but this will need the state to deliver on its proposed spending restraint and wage control. If successful, the government could achieve a primary budget surplus as soon as next fiscal year (for the first time since FY08/09) and keep debt to around 70% of GDP. Achieving this would be an important step towards setting the public finances on a sustainable path, and alleviating South Africa's long-standing fiscal challenges and mitigating debt vulnerabilities.

[13] The labour court ruled in the government's favour in December 2020, but a reversal could add as much as ZAR38bn to the wage spending base.

Debt levels have risen sharply in just over a decade, increasing from less than 25% of GDP in FY08/09, with the large debt stock playing an instrumental role in pushing up borrowing costs, and generating concerns over whether the government achieve the primary balances needed to repay its debt.[14] Debt service costs currently absorb more than 4% of GDP and about 17% of tax revenues, with these ratios set to worsen in the coming years.[15] Although foreign ownership has declined by more than 10ppt over the past two and a half years, at 28% it remains relatively high from an EM perspective. These pressures are cushioned by the structure of South Africa's sovereign debt with 90% ZAR-denominated and the long average maturity (13 to 14 years for both local and external debt) dulling the effects of adverse exchange rate movements and reducing rollover risks.

However, the expenditure risks outlined above, signs that some of the commodities-driven revenue windfall is already being spent, and South Africa's low potential growth rate, leave us cautious about the long-term path for fiscal consolidation. Indeed, our forecasts see little prospect of debt declining in an environment where long-term growth struggles along at 1% per year. As such, our concerns around long-term fiscal sustainability remain undimmed, with debt stabilisation reliant on the implementation of reforms that boost long-term growth, and tackle the underlying macro risks associated with high debt levels, debt service costs, and elevated funding needs.

32. We still struggle to see debt stabilising if potential growth remains at c1%



Source: National Treasury, HSBC estimates

[14] A simplistic approach to modelling debt sustainability using our long-term forecasts for real GDP growth and real interest rates would imply that a c1% of GDP primary surplus is needed to stabilise debt.
[15] We would also argue that South Africa's debt build-up has been primarily financing swelling government wages, rapidly rising debt service costs, and more recently bailouts for financially strained state-owned companies rather than borrowing to invest in infrastructure and human capital improvements that enhance potential growth.

Disclosure appendix

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