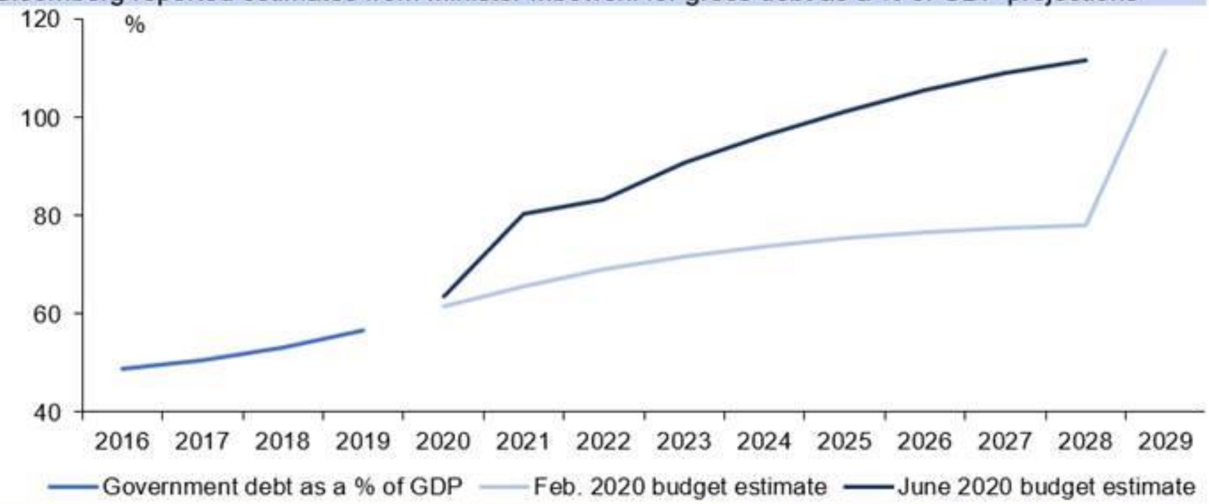
SA Economics

Rand Note

Monday 22 June 2020

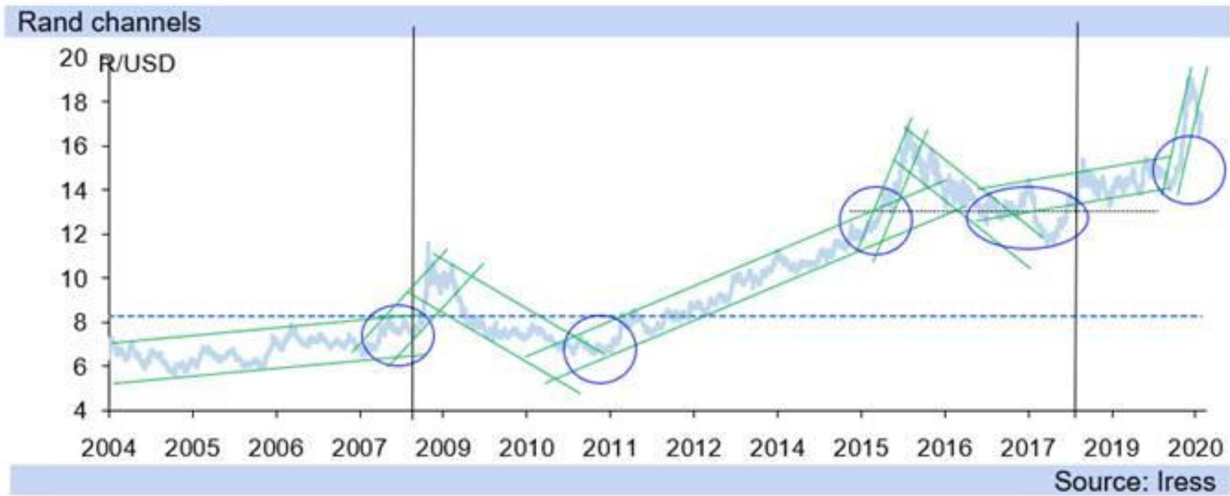
Rand weighed down by SA's deteriorating fiscal metrics, as Finance Minister announces yesterday higher borrowings, likely heralding further credit rating downgrades for SA and so increasing the risk of falling into the C grade category

Bloomberg reported estimates from Minister Mboweni for gross debt as a % of GDP projections



Source: National Treasury, Bloomberg

Note: Chart shows estimates for fiscal year that ends March 31



- Last week the rand had already run weaker, to R17.48/USD, R19.64/EUR and R21.76/GBP on market worries over potentially developing second rounds of Covid-19 infections in certain countries, even if just in some clusters, as well as rising concerns over the recovery of the global economy.
- Today the rand traded at R17.42/USD, R19.53/EUR and R21.63/GBP, having consolidated weaker, after its strong run from R19.35/USD to R16.33/USD from April to early June, disrupted also by the very weak FOMC projections on the US economy for this year, as financial markets in general have seen some consolidation.
- SA's sharply deteriorating government finances also add an underpin to the rand's consolidation, with Finance Minister Mboweni recently outlining a sharp rise in government's projections of its gross debt as % of GDP this year (2020/21), to about 80%, from a previous estimate of 65.6%.
- SA's debt is further estimated to rise to 90.9% by 2023 and over 100% by 2025, climbing to a massive 113.85 by 2029. SA is likely headed for further substantial credit rating downgrades from Moody's, Fitch and S&P, and likely quite rapidly, from out of the BB category into the single B category, which is just above C grade.
- The special Budget on Wednesday 24th June, at 3pm, this week is likely to reveal a budget deficit for this year projected at close to 15% of GDP, a very severe injury to government finances as the economy likely contracts by 10.1% y/y this year, and we also expect a huge collapse in tax revenue of up to R300bn.

- SA has seen the yields on its government bonds rise in anticipation of the official publication of SA's substantially higher debt projections on Wednesday, with the R2030 at 9.34% this morning from its close of 9.19%, and the R186 at 7.73% from 7.61% on Friday.

- However, absent the substantial bond buying programme of the South African Reserve Bank, domestic bond yields would likely be much higher in SA, and the Reserve Bank cannot suppress yields forever, nor will Treasury's extremely large bond issuances always be met with endless investor appetite.

- That is, there are limits to the amount of government debt the South African Reserve Bank may purchase/own. This is due both to a cap on bond purchases in primary market legislation and the Southern African Development Community's treaty limitation that Central Banks should not provide more than 10% of funding to government.

- The rand is likely to see some weakness this week on the budget projections, with SA sinking deeper into a debt trap. South Africa has been borrowing to pay for its current expenditure, which includes civil servant salaries and wages, while experiencing a falling economic growth and revenue trend over the past decade.

Economic Scenarios: note updated forecasts

Extreme Up case 1%

	Q1.20	Q2.20	Q3.20	Q4.20	Q1.21	Q2.21	Q3.21	Q4.21
USD/Rand (average)	15.38	15.00	14.00	13.00	12.00	11.00	10.00	9.00
Repo rate (end rate)	5.25	3.50	3.50	3.50	3.50	3.50	3.50	3.50

Impact of Covid-19 pandemic very rapidly resolved - economic growth of 3–5%, then 5-7% for SA. Good governance, growth-creating reforms (structural constraints overcome), strengthening of property rights - individuals obtain title deeds in EWC – no nationalisation. High business confidence and fixed investment growth, substantial FDI inflows, strong fiscal consolidation (government debt falls back to low ratios of 2000s). Strong global growth, commodity boom. Stabilisation of credit ratings, then credit rating upgrades.

Up case 4%

	Q1.20	Q2.20	Q3.20	Q4.20	Q1.21	Q2.21	Q3.21	Q4.21
USD/Rand (average)	15.38	16.00	15.00	14.00	13.50	12.00	11.50	11.00
Repo rate (end rate)	5.25	3.75	3.75	3.75	3.75	3.75	3.75	3.75

Quick rebound from Covid-19 pandemic, rising confidence and investment levels - structural problems worked down. No further credit rating downgrades, rating outlooks move to stable and eventually positive, strong fiscal consolidation (government debt projections fall substantially). Global risk-on, global demand quickly returns to trend growth. Limited impact of expropriation without compensation) to abandoned, unused, labour tenants" and government land (individuals are new owners and receive title deeds) does not have a negative effect on economy - no nationalisation.

Base case 43%

	Q1.20	Q2.20	Q3.20	Q4.20	Q1.21	Q2.21	Q3.21	Q4.21
USD/Rand (average)	15.38	18.00	17.00	16.50	15.75	15.50	15.50	15.00
Repo rate (end rate)	5.25	3.75	3.75	3.75	4.00	4.25	4.50	4.50

Temporary sharp global slowdown and global financial turmoil from Covid-19 pandemic (severe currency depreciation, low interest rates) – eventually sufficient global and domestic monetary and other policy supports to growth and financial markets occur and risk sentiment stabilises. South Africa exits recession in Q3.20. Market unfriendly policies like expropriation of private sector property put on hold in the crisis. SA remains BB+ rating from Moody's - government debt projections stabilise.

Lite (domestic) Down case 42%

	Q1.20	Q2.20	Q3.20	Q4.20	Q1.21	Q2.21	Q3.21	Q4.21
USD/Rand (average)	15.38	19.50	22.00	20.00	18.50	17.00	16.50	16.00
Repo rate (end rate)	5.25	4.25	4.25	4.50	4.75	4.75	4.75	5.00

The international risk sentiment environment is that of the base case. South Africa continues to fail to see its debt projections stabilise and loses its BB+ rating from Moody's and falls towards B ratings from all three rating agencies. More severe recession in SA over 2020 than in the expected case. Expropriation of some private commercial sector property without compensation, with some negative impact on the economy. Business confidence depressed even further, significant rand weakness, significant load shedding and weak investment growth until substantial fiscal repair ultimately effected.

Severe down case 10%

	Q1.20	Q2.20	Q3.20	Q4.20	Q1.21	Q2.21	Q3.21	Q4.21
USD/Rand (average)	15.38	22.00	24.00	21.00	20.00	19.00	18.00	16.50
Repo rate (end rate)	5.25	4.50	4.75	5.00	5.50	6.00	6.50	7.00

Lengthy global recession on impact of Covid-19 – global financial crisis – insufficient monetary and other policy supports to growth domestically and internationally. Depression in SA, unprecedented rand weakness. Nationalisation of private sector property (title deeds not transferred to individuals). SA rated single B from all three key agencies, with further rating downgrades occurring into C grade as government finances deteriorate (debt projections elevate even further - fail to ever stabilise. Government borrows from increasingly wider sources as it sinks deeper into a debt trap), eventually include widespread services load shedding, strike action and civil unrest.

Note: Event risk begins Q2.20. Source: Investec

Lite Down Case: Exchange Rates forecasts												
	2020				2021				2022			
	Q1.20	Q2.20	Q3.20	Q4.20	Q1.21	Q2.21	Q3.21	Q4.21	Q1.22	Q2.22	Q3.22	Q4.22
USD/ZAR	15.38	19.50	22.00	20.00	18.50	17.00	16.50	16.00	15.50	16.00	16.50	16.00
GBP/ZAR	19.64	24.18	27.50	25.20	23.50	21.76	21.45	21.28	20.77	21.60	22.44	21.92
EUR/ZAR	16.95	21.26	23.98	22.00	20.35	18.70	18.32	17.92	17.52	18.24	18.98	18.56
ZAR/JPY	7.12	5.54	4.95	5.50	5.89	6.35	6.42	6.56	6.84	6.63	6.42	6.63
CHFZAR	15.89	20.31	22.68	20.41	18.69	17.00	16.50	16.00	15.50	16.00	16.50	16.00
AUDZAR	10.09	12.29	14.30	13.40	12.40	11.56	11.22	11.04	10.85	11.20	11.72	11.36
GBP/USD	1.28	1.24	1.25	1.26	1.27	1.28	1.30	1.33	1.34	1.35	1.36	1.37
EUR/USD	1.10	1.09	1.09	1.10	1.10	1.10	1.11	1.12	1.13	1.14	1.15	1.16
USD/JPY	109	108	109	110	109	108	106	105	106	106	106	106

Note: averages, Source: Investec, Iress

Severe Down Case: Exchange Rates forecasts												
	2020				2021				2022			
	Q1.20	Q2.20	Q3.20	Q4.20	Q1.21	Q2.21	Q3.21	Q4.21	Q1.22	Q2.22	Q3.22	Q4.22
USD/ZAR	15.38	22.00	24.00	21.00	20.00	19.00	18.00	16.50	16.80	17.50	18.00	17.00
GBP/ZAR	19.64	27.28	30.00	26.46	25.40	24.32	23.40	21.95	22.51	23.63	24.48	23.29
EUR/ZAR	16.95	23.98	26.16	23.10	22.00	20.90	19.98	18.48	18.98	19.95	20.70	19.72
ZAR/JPY	7.12	4.91	4.54	5.24	5.45	5.68	5.89	6.36	6.31	6.06	5.89	6.24
CHFZAR	15.89	22.92	24.74	21.43	20.20	19.00	18.00	16.50	16.80	17.50	18.00	17.00
AUDZAR	10.09	13.86	15.60	14.07	13.40	12.92	12.24	11.39	11.76	12.25	12.78	12.07
GBP/USD	1.28	1.24	1.25	1.26	1.27	1.28	1.30	1.33	1.34	1.35	1.36	1.37
EUR/USD	1.10	1.09	1.09	1.10	1.10	1.10	1.11	1.12	1.13	1.14	1.15	1.16
USD/JPY	109	108	109	110	109	108	106	105	106	106	106	106

Note: averages, Source: Investec, Iress

- This decade is beginning with a massive plunge in the health of government finances, versus the gradual beginning of deterioration at the start of the last decade. The massive fiscal deterioration now envisioned will catch up with both the rand and bond yields in South Africa at some stage, with both at risk of being materially weaker in the future.

- It is not possible to continuously borrow out of debt, higher debt is higher debt and repayments have to be made to avoid default. From a risk perspective, the skew remains to the downside for the rand, and SA is on a negative outlook from Moody's, at Ba1 (BB+). The agency will likely downgrade SA after the budget, if not in November then sooner.

- SA has been falling though the credit ratings increasingly quickly, and is at BB from Fitch (for both its foreign and local currency ratings), while from Standard and Poor's SA's local currency rating is BB but its foreign currency (country) rating is BB-. The next step after BB- is single B, followed by the C grade ratings and then D, for default.

- While the Covid-19 pandemic is expected to wane as a key risk factor to South Africa this year, ongoing weak and anaemic domestic economic growth is likely to continue to be SA's key threat, not from the lockdown's temporary lagged effects, but due to the ongoing lack of substantial, effective growth enhancing government reforms in SA.

- There is unlikely to be a material rebound in growth in SA in 2021, we forecast only 1.6% y/y after 2020's contraction of -10.1% y/y. National Treasury is likely to revise their GDP growth forecast for 2020 closer to ours, but they are also likely to continue overestimating economic growth forecasts in their three year forward-looking MTEF period.

- The ongoing weak ability of SA to meet the electricity needs of an economy growing at over 1.0% y/y (3-5% pa real growth is needed to reduce unemployment) will be a key limitation to economic growth in the second half of this year and into next year. Even SA's 16.3% qqsaa rebound in SA will be threatened by Eskom's weak supply capacity.

- The budget adjustment this week will also detail the reallocation of R130bn in expenditure from previous allocations towards supporting health and safety expenditure (in public institutions/areas including schools hospitals etc) in the face of Covid-19. We expect previously allocated arts, sports, culture and infrastructure spending will be key losers.

- The wage bill of civil servants is a key portion of government expenditure and is an area where substantial savings can be made. The private sector will see substantially lower renumeration than last year, and civil servants should not be in line for renumeration increases above inflation, any bonusses or automatic salary progressions given the crisis.

- Lack of sustainability in the budget will catch up with the rand over the long term. While it is in line to average very close to R18.00/USD this quarter, and could see R17.00/USD for Q3.20 on the effects of global QE, longer-term persistent depreciation could become a reality if government does not finally effect marked fiscal consolidation.

Expected Case: Exchange Rates forecasts

	2020				2021				2022			
	Q1.20	Q2.20	Q3.20	Q4.20	Q1.21	Q2.21	Q3.21	Q4.21	Q1.22	Q2.22	Q3.22	Q4.22
USD/ZAR	15.38	18.00	17.00	16.50	15.75	15.50	15.50	15.00	14.50	14.75	15.00	14.50
GBP/ZAR	19.64	22.32	21.25	20.79	20.00	19.84	20.15	19.95	19.43	19.91	20.40	19.87
EUR/ZAR	16.95	19.62	18.53	18.15	17.33	17.05	17.21	16.80	16.39	16.82	17.25	16.82
ZAR/JPY	7.12	6.00	6.41	6.67	6.92	6.97	6.84	7.00	7.31	7.19	7.07	7.31
CHFZAR	15.89	18.75	17.53	16.84	15.91	15.50	15.50	15.00	14.50	14.75	15.00	14.50
AUDZAR	10.09	11.34	11.05	11.06	10.55	10.54	10.54	10.35	10.15	10.33	10.65	10.30
GBP/USD	1.28	1.24	1.25	1.26	1.27	1.28	1.30	1.33	1.34	1.35	1.36	1.37
EUR/USD	1.10	1.09	1.09	1.10	1.10	1.10	1.11	1.12	1.13	1.14	1.15	1.16
USD/JPY	109	108	109	110	109	108	106	105	106	106	106	106

Note: averages, Source: Investec, Iress

Up Case: Exchange Rates forecasts												
	2020				2021				2022			
	Q1.20	Q2.20	Q3.20	Q4.20	Q1.21	Q2.21	Q3.21	Q4.21	Q1.22	Q2.22	Q3.22	Q4.22
USD/ZAR	15.38	16.00	15.00	14.00	13.50	12.00	11.50	11.00	10.80	10.60	10.40	10.65
GBP/ZAR	19.64	19.84	18.75	17.64	17.15	15.36	14.95	14.63	14.47	14.31	14.14	14.59
EUR/ZAR	16.95	17.44	16.35	15.40	14.85	13.20	12.77	12.32	12.20	12.08	11.96	12.35
ZAR/JPY	7.12	6.75	7.27	7.86	8.07	9.00	9.22	9.55	9.81	10.00	10.19	9.95
CHFZAR	15.89	16.67	15.46	14.29	13.64	12.00	11.50	11.00	10.80	10.60	10.40	10.65
AUDZAR	10.09	10.08	9.75	9.38	9.05	8.16	7.82	7.59	7.56	7.42	7.38	7.56
GBP/USD	1.28	1.24	1.25	1.26	1.27	1.28	1.30	1.33	1.34	1.35	1.36	1.37
EUR/USD	1.10	1.09	1.09	1.10	1.10	1.10	1.11	1.12	1.13	1.14	1.15	1.16
USD/JPY	109	108	109	110	109	108	106	105	106	106	106	106

Note averages, Source: Investec, Iress

Extreme Up Case: Exchange Rates forecasts												
	2020				2021				2022			
	Q1.20	Q2.20	Q3.20	Q4.20	Q1.21	Q2.21	Q3.21	Q4.21	Q1.22	Q2.22	Q3.22	Q4.22
USD/ZAR	15.38	15.00	14.00	13.00	12.00	11.00	10.00	9.00	8.00	8.00	8.00	8.00
GBP/ZAR	19.64	18.60	17.50	16.38	15.24	14.08	13.00	11.97	10.72	10.80	10.88	10.96
EUR/ZAR	16.95	16.35	15.26	14.30	13.20	12.10	11.10	10.08	9.04	9.12	9.20	9.28
ZAR/JPY	7.12	7.20	7.79	8.46	9.08	9.82	10.60	11.67	13.25	13.25	13.25	13.25
CHFZAR	15.89	15.63	14.43	13.27	12.12	11.00	10.00	9.00	8.00	8.00	8.00	8.00
AUDZAR	10.09	9.45	9.10	8.71	8.04	7.48	6.80	6.21	5.60	5.60	5.68	5.68
GBP/USD	1.28	1.24	1.25	1.26	1.27	1.28	1.30	1.33	1.34	1.35	1.36	1.37
EUR/USD	1.10	1.09	1.09	1.10	1.10	1.10	1.11	1.12	1.13	1.14	1.15	1.16
USD/JPY	109	108	109	110	109	108	106	105	106	106	106	106

Note: averages, Source: Investec, Iress