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Prospects of the South Africa's Economy

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＜Summary＞

- In the general election held in May 2019, the ruling party African National Congress (ANC) maintained a majority of seats with Mr. Matamela Cyril Ramaphosa reelected as president. Going forward, it is expected the government tackles the agendas for economic revitalization including structural reforms, but with economic stagnation and increasing instability in his support base, it is likely he will face a difficulty in continuing to take policies that are unpopular among the people.
- The pace of economic growth is decelerating with real GDP growing at around 1% annual rate. In the background are the decrease in direct investment flows from overseas, stalled industrial diversification and sophistication, and resulting failure to increase supply capacity and employment creation. The government has made efforts to promote reforms to attract foreign investment into the country, but it is not easy to realize the reforms, and therefore the possibility that the slow growth will continue not only in the near term but also over the medium and long term should be fully taken into consideration.
- In the banking sector, although the non-performing ratio of small- and medium-scaled banks in South Africa is somewhat rising, there is no big concern over the soundness of the banking system as the capital adequacy ratio is still high enough.
- The fiscal deficit is expected to increase, because, in addition to the prospect that the

economy will not recovery soon, the government will be forced to make financial support to Eskom, an electricity public utility which has suffered from unfavorable business performance. In addition to the already high public debt outstanding, contingency liabilities of the state owned entities including guaranty of liabilities have been increasing year by year. Although the government has announced the financial support to Eskom, the rating assessment of major rating agencies on South Africa is worsening as no concreate restructuring plan for Eskom has been shown despite its increased fiscal burdens.

- The current account deficit is expected to remain at higher than 3% of GDP as exports will stagnate due to unsatisfactory supply conditions reflecting stagnant investment, in addition to moderate fall of resources prices. In the financial account, inflows of portfolio and other investments have been on a rise, while direct investment has stagnated, constituting a continued fragile structure for a capital flight.
- The share of external debt denominated in the local currency is still high, and coupled with ample foreign exchange reserves, South Africa is less vulnerable to external shocks. Moody's International Service forecasts that investment funds of $8-9 billion will outflow from South Africa if it downgrades the rating of the government bonds to below-investment (speculative) grade, but that amount still falls below the international reserves. In addition, South Africa's international investment position continues to show a net excess of assets, therefore, it is quite unlikely that the downgrading leads to an immediate default on external obligations.
- Major risks in the future include (i) increase of fiscal burden due to failed/delayed restructuring plan of Eskom, (ii) expansion of capital outflows triggered by downgrading by Moody's of foreign-currency long-term bonds, (iii) lack of transparency of structural reforms of the economy by the Ramaphosa administration, and (iv) prolonged subdued economic growth.
- Rating agencies point the problems of fiscal problem associated with unfavorable business performance of state-owned entities like Eskom, stagnant economic growth, and low resiliency to financial shocks. Specifically the fiscal developments require attention as they represent a risk which is most likely to come up to the surface in the future and which will become a factor for downgrading by Moody's.

＜Text＞

Although the decline of the South African Rand (hereafter the rand) and capital outflow have shown a sign of being curbed in 2019 as the US monetary policy stance turned to “doves”, the real economy continues to be in no prospect for a recovery.

It is expected that the reconstruction of the economy will start under President Ramaphosa who took office in February 2018 and was re-elected in the election of May 2019. However, South Africa has been faced with many longtime unresolved problems such as deteriorated fiscal condition associated with poor business performance of SOEs, fight against corruption, and structural reforms aimed for economic revitalization, and the outlook of its economy is still unclear.

In light of the foregoing, I will look at in this article the current situation of South Africa’s economy and examine its prospects and future risk factors.

1. Political developments

In the quinquennial general election held in May 2019, the ruling party African National Congress (ANC) narrowly secured the majority to reelect Mr. Ramaphosa as president[1]. The president reduced the number of new cabinet members from 36 to 28 to improve administrative efficiency while appointing more women and young people. The re-appointment of Mr. Mboweni who has strong connection with the economic circles as Finance Minister and Mr. Gordhan who promoted fiscal consolidation plans including reconstruction of public electric utility Eskom before the election as Minister for Public Enterprises imdicates President Ramaphosa’s strong will to actively implement reforms he set for in 2018. On the other hand, re-appointment of corruption-tainted Mr. David Mabuza as Deputy President and appointment as Minister of Cooperative Governance, Traditional Affairs of Dr.(Ms.) Dlamini-Zuma who fought the 2017 election against President Ramaphosa for president of the African National

[1] The ruling party won 57.5% of votes, declining from 62.2% it gained in 2014, while the Democratic Alliance (DA) mainly backed by the white and the Economic Freedom Fighters (EFF) that gained broader support among the black poor made a leap forward.

Congress are pointed out to be a result of possible negotiations among the factions within the ANC[2].

When he took the office of president in 2018, President Ramaphosa set forth structural reforms for economic revitalization (investment promotion, infrastructure development, land reform[3], SOE reform, etc. Table 1) as well as fiscal consolidation and eradication of corruption. However, the progress had been slow due to considerations for power balance in the ANC party in anticipation for the May 2019 election. From now on, however, the government is required to deal with these agenda in earnest.

However, since the economy remains subdued and the support base within the ruling party is not so strong coupled with a declining approval rate for the ANC, it is also considered that the government may face difficulty in promoting unpopular policy measures that include job and cost reduction of SOEs, land reforms and labor market reforms.

Table 1　Structural Reforms aimed for Economic Revitalization

Policies	Contents	Progress
Investment promotion	Attractinig new invetments amounting to $100bn over 5 years.	Projects equivalent of R250bn out of R300bn (about $20bn) revealed at a 2018 investers meeting are in progress. Another investors meeting scheduled in November.
Infrastructure development	Mending of aged equipment t to ensure stable supply of power and water. Establishment of infrastructure fund of R100bn (about $7bn)	Decrepit electric facilities are being mended in relation to Eskom reform.
Land reforms	To accelerate the move to return the lands to black people, the government proposed in July 2018 an amemdment to the constitution so that it enables the government to expropriate the lands from the current owners without compensation.	The government is in preparation to take procedures for amendment by establishing an advisory committee of experts, etc.
Reforms of State Owned Enterprises (SOEs)	Fiscal burdens are growing due to poor performance of SOEs includinig Eskom. The government strengthens control of them by job cuts and cost reduction while considering their privatization in the medium run.	In exchange for the financial supports to Eskom, the government is making a plan to streamline the SOEs.
Labor market reform	Creation of new jobs of 275 thousands over five years. Efforts to restrain wage increases in the public sector. Review of labor policy that is strongly of labor protecting in strikes and wage negotiations.	Major legislations have already been enacted. The government is making preparation for ways to implement them.
Education reform	Reform of education system and improvement of academic ability of new graduates.	Strong power of teachers' unions is preventing the reforms.

（Source）Various reports

[2] In the presidential election of the ANC held in December 2017, Mr. Ramaphosa who called for eradication of corruption narrowly won the victory against Ms. Dlamini-Zuma, former wife of the former President Zuma and the Ramaphosa administration formed a cabinet while giving consideration to the Zuma faction, but the policy of the president is still maintained.

[3] The government introduced a policy to return the lands mandatorily expropriated by the white ruling class in the days of apartheid to the people who used to own them. However, as of 2018 more than 70% of the land was still owned by the white people who account for about 20% of the population, giving a detrimental impact on the economic development.

2. Economic Performance

（1）Current situation

After the global financial crisis the pace of South Africa's economic growth has decelerated and its growth rate remained at around annual 1 % in the last few years, lower than in other emerging countries (Figure 1). Real GDP grew by 0.8% in 2018, reflecting a decrease of agricultural production due to severe drought, decline in industrial production due to delayed revision of Mining Charter[4] (Figure 2). By component, household consumption continued to grow at above 1%, while fixed capital investment went into a negative range due to reduction of public investment oriented for expenditure restraint and dampened business equipment investment in a continued political uncertainty.

In the first quarter of 2019, economic activities stalled affected by the rotating interruption of electric service and stop of electric transmission by Eskom, with the real GDP growth falling to annualized negative 3.2% over the previous quarter. The South African Reserve Bank (central bank, SARB) forecasts that the yearly growth rate for 2019 will decline to 0.6%, substantially lower than its April forecast of 1.4% year over year[5].

Unemployment rate jumped to over 29% in the second quarter of 2019, the highest ever in the last eleven years, after it remained at a high level of 27% plus for a while (Figure 3). Although President Ramaphosa set forth employment creation policy in October 2018, it will take time before unemployment rate improves as he needs to first reduce the workforce of SOEs and civil service workers to promote fiscal consolidation. Further, the corporate business confidence index[6] declined to 28 in the second quarter after it once improved to 40 at the time of inauguration of President Ramaphosa in early 2018 (Figure 3).

The exchange rate of the rand against the dollar fell to around 15 rand mark for the first time in two years affected by the US rate hikes in 2018 and the Turkey shock (Figure 4). The fall was temporarily suspended in early 2019 as the US monetary policy stance shifted to the "doves". Since then, although the rand rose for a while against the background of reelection of president

4 It is a system to promote a larger distribution of ownership of mining interests to black workers who suffered from disadvantages in the days of Apartheid, aiming at improving their economic strength. To improve their unemployment, the former Zuma administration tried in 2017 to adopt such measures as expansion of black ownership of mining and coal rights, increase of procurement ratio of mining materials from South African companies, and increase of black employment ratio, but they triggered a protest from mining circles. The Ramaphosa administration offered an amendment that took into consideration the intentions of mining circles and intraparty opinions, which was finally approved in December 2018.

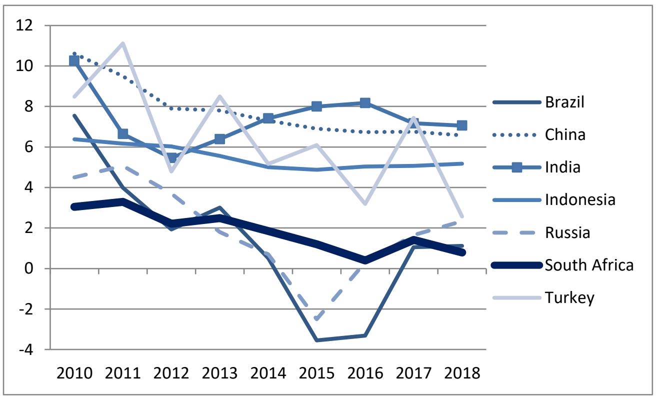
5 In July 2019, the IMF also reduced the real GDP growth forecast for 2019 to 0.7% from its April forecast of 1.2%

6 Published every quarter by the Bureau of Economic Research of South Africa and the numbers above 50 indicate economic booms and those under indicate busts.

Ramaphosa and heightened expectations for further rate cuts in the US, it is falling again reflecting the lackluster economy due to planned blackout of Eskom and negative assessment of South Africa by major rating agencies associated with the fiscal deterioration (see Chapter 2 (2) for details).

Inflation rate rose to the 5% order year over year in the latter half of 2018, due to depreciation of the rand and rise of oil prices (Figure 5). In addition, as the long term inflationary risk increased due to continual increases of electricity charges and other factors, the SARB (central bank) raised its policy in November 2018 to 6.75%, for the first time in almost three years (Figure 5). Since then, inflation has remained stable at 4%-plus level. Inflation expectation has also been well anchored, and the future inflation rate is expected to remain within the range (3 to 6%) of inflation target set by the central bank. Under these circumstances, the SARB cut the policy rate to 6.5% in July 2019 as part of economic stimulus packages[7].

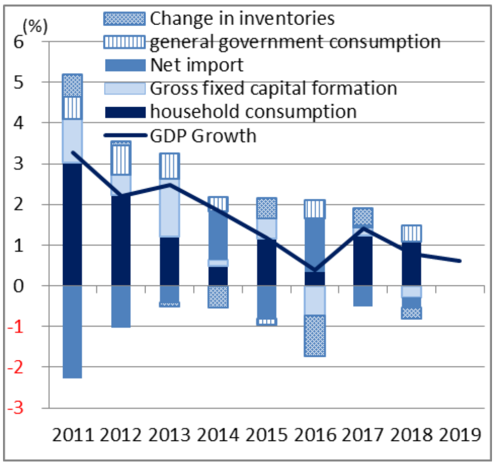
Figure 1: Real GDP Growth Rate by Country



（Source）IMF

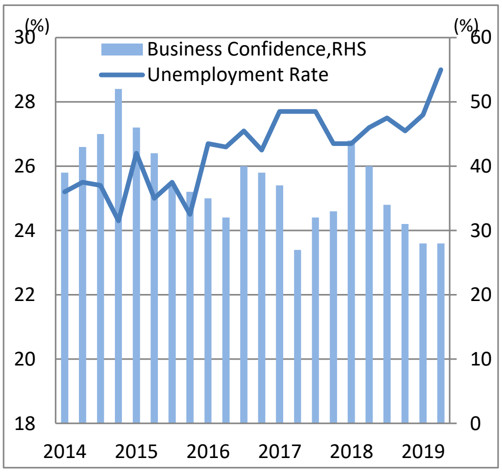
[7] The rate cut did not indicate the beginning of an easy money cycle, with the SARB showing a cautious attitude to an additional monetary easing.

Figure 2　Real GDP by Component



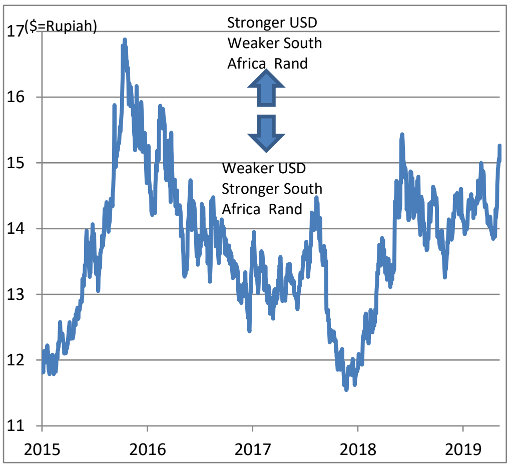
（Source）Statistics Bureau
Note: SARB forecast for 2019

Figure 3　Unemployment rate, business confidence (Quarterly)



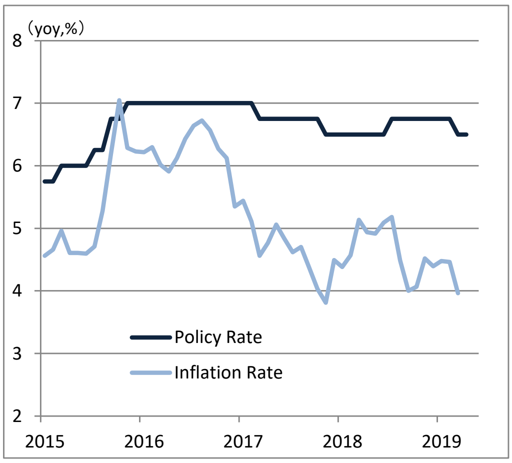
(Source) Statistics Bureau, Institute of SA Economic Affairs
Note: Numbers above 50 of Business confidence Index indicate boom and those below bust.

Figure 4 : Exchange rates of the Rand



（Source）Reuters

Figure 5: Inflation, policy rates



（Source）Bureau of Statistics, SARB

（2）Background of subdued growth

In the background of subdued growth of the South African economy, it is considered that the decrease in inflow of direct investment from abroad has affected. Since 2014, the GDP ratio of fixed capital investment has been declining due to a decrease in foreign direct investment in South Africa (Figure 6), with its level remaining low as compared to other emerging countries (Figure 7). Going forward, it is hard to expect a rapid recovery of investment for the moment and it is expected that the domestic demand on the whole is expected to generally continue to be flat.

While facing with the slow inflow of foreign capital, the efforts to promote industrial diversification and sophistication through attracting foreign manufacturing by which to change economic structure much dependent on mining have almost failed, thus lowering the productive capacity and hampering the creation of new employment. The limited supply capacity to meet the growing domestic demand has led to a structural tendency of the current account that an increase of imports to meet the shortage expands the current account deficits.

In South Africa, large new investment opportunities are few compared to other rapidly developing emerging countries in Asia, as most of the infrastructures had been consolidated by the 1990s when the white people had assumed the reins of government. However, the then constructed equipment has become older, while infrastructure for electricity and water supply has been poorly provided. Furthermore, South Africa moved down to 82nd on the list of ease of doing business in the "Doing Business 2018" of the World Bank from 32nd 10 years ago, due to corruptions in the government and public entities and recurrent labor disputes like strikes, in addition to low level of education.

To improve such investment environment and encourage foreign investment, the reforms for economic revitalization of President Ramaphosa (as noted above) are indispensable. However, it is not easy to realize them and we should be prepared for the possibility that the economy will continue to grow slowly even in the medium and long run[8].

Incidentally, as a good news for an economic recovery, African Continental Free Trade Agreement (AfCFTA) [9] came into force (became operational) this May. `President Ramaphosa lauded this agreement, commenting that AfCTA would create many opportunities and benefits for South Africa and would grow and diversify the South African economy through the reduction of inequality and unemployment. However, as it is considered to take a considerable time[10] before it starts to get operational, it is unlikely for the AfCFTA to serves African countries as a donating device for breaking away from low growth. On the African Continent, several regional communities have already formed customs unions, and therefore it is considered to take some time for them to agree on any common operational rules. In addition,

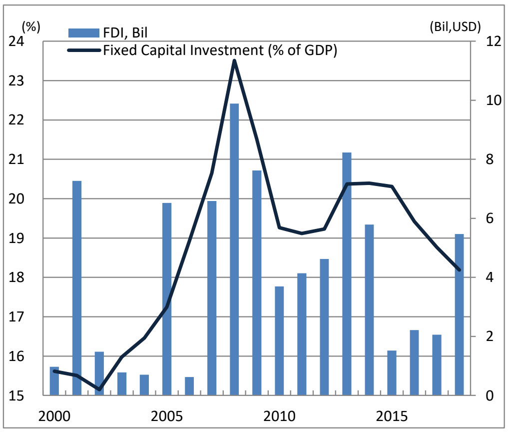
[8] According to the forecast of the SARB, the economy will continue to grow below 2% until 2020 and at last reach 2% in 2021.

[9] Among 55 member countries of the African Union, 53 countries have agreed to AfCFTA. Economic scale in GDP amounts to $3.2 trillion with the population of 1.2 billion. By eliminating customs tariffs and non-customs tariffs on the intra-African exports and imports, it plans to increase the trade values from current 15% of GDP to 52% of GDP by 2022.

[10] Mr. Carlos Ropez, former chairman of United Nations' Economic Commission to Africa, who is the key player of the agreement, once commented that it would take at least three years before the agreement starts to operate.

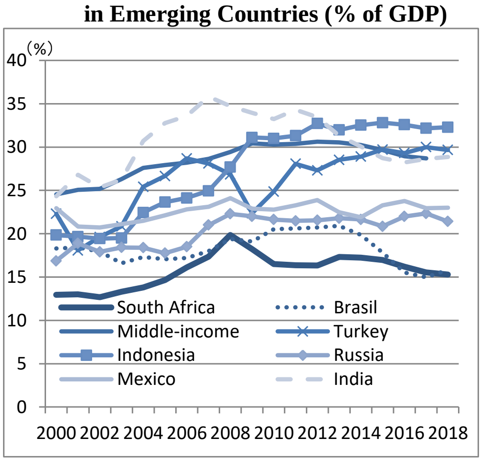
infrastructure is still inadequate in many parts of African region, and it is also seen that it will take some time to invigorate the regional trades as the distribution cost is so high.

Figure 6: Fixed Capital Investment (% of GDP) and FDI



（Source） SARB

Figure 7: Fixed Capital Investment in Emerging Countries (% of GDP)



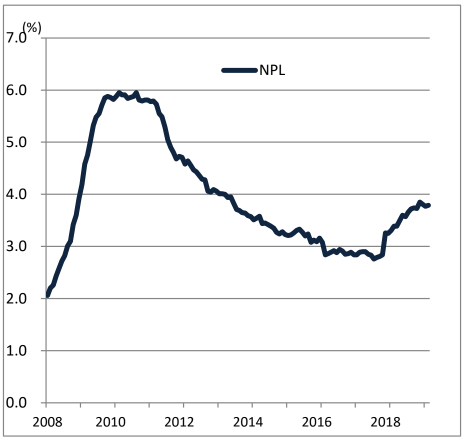
（Source） WB

3. Evaluation of financial system

By asset size, five largest banks hold a share of more than 90% in the South African banking sector. Although the non-performing loan (NPL) ratio of the whole banking sector has risen to the order of 3% reflecting subdued economic growth, it remains at a lower level than 5% it used to have in around 2009-2011(Figure 8). By banking size, while NPL ratio of small and medium sized banks has risen to the order of 9%, the major 5 banks keep low level of 2%. Concerns for the soundness of the financial system are kept low with capital adequacy ratio of the banking sector exceeding 16% (Figure 9).

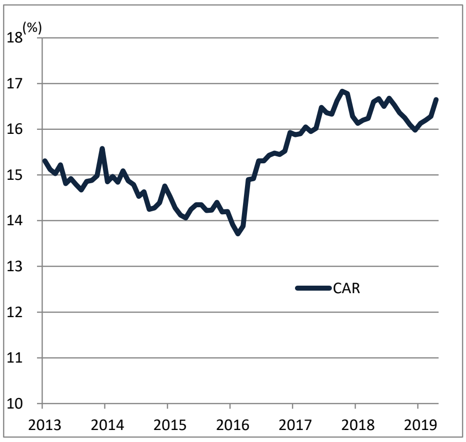
Moody's comments that the banking sector with ample capital and financial market of South Africa are anchorage for the credibility of South Africa. Also the IMF evaluated in June 2019 at its Article IV consultation visit that the financial system is kept stabilized.

Figure 8: Non-Performing Loan Ratio of Banking Sector



（Source） SARB

Figure 9: Capital Adequacy Ratio of Banking Sector



（Source） SARB

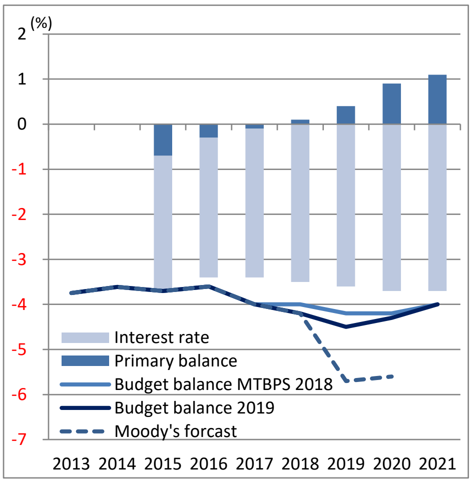
4. Outlook for Eskom reconstruction and its impact on finance

（1） Fiscal developments

Fiscal deficit remained at above 4% in the fiscal year 2018 due to decreased tax revenues reflecting economic slowdown and delayed tax collection procedures (Figure 10). The fiscal management is expected to be harder in FY 2019, as it will take time for the economy to recover and the government will be forced to make financial support to the state power utility Eskom that suffers from slumping business. In the budget draft for FY 2019 revealed in February, the government decided, instead of making debt relief of R100 billion Eskom required, to give support amounting to R69 billion (about 1.2% of GDP) over the three years to subdivide it into three components of generation, transmission and distribution. While the government took measures like reduction of employment cost by promoting early retirement system for civil workers, tax increases for fuel, tobacco and alcohol, etc., the budget balance for the next three years was revised downward from the medium fiscal plan (MTBPS) set out last year (Figure 10).

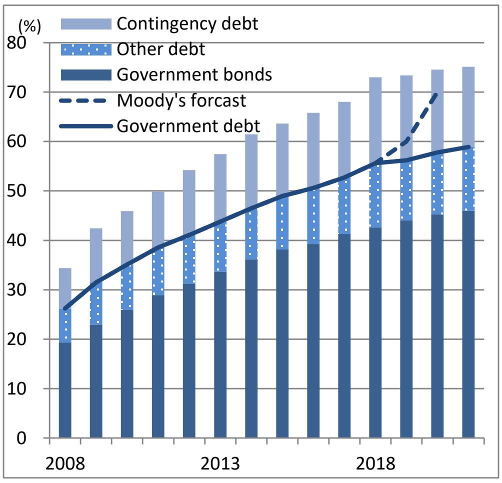
Public debt expanded to 55% of GDP in FY2018 due to increase of local currency government bonds (Figure 11). The government explained that nearly 90 % of the public debt outstanding was accounted for by the local currency medium- and long-term government bonds, and the short-term repayment risk is low because the government actively manages the debt outstanding together with debt refinancing risk. However, the contingency debt outstanding including debt guarantees to SOEs like Eskom has been increasing year by year, expanding to 17% of GDP.

Figure 10: Budget Balance (% of GDP)



（Source） Ministry of Finance
Note: Forecasts for 2019 and after.

Figure 11: Public Debts, Contingency Debts (% of GDP)



(Source) SARB
Note: Forecasts for 2019 and after. Dotted line by Moody's.

（2） Outlook of Eskom restructuring and its impact on the budget

The closing account of Eskom for Fy2017[11] resulted in a deficit as operation and financing costs increased while sales stagnated. In FY2018 further increase of the operation costs resulted in a bigger deficit (Table2). The debt outstanding reached R441 billion as of March 2019, of which R273 billion (about 5% of GDP) had been guaranteed by the government[12]. The payment of electricity charges by local municipalities and Soweto[13] has been long overdue[14], it is said, keeping the liquidity of Eskom scarce. In addition to the decrepit equipment making the energy supply unstable, intensifying competition with private renewable energy sector has made it difficult to anticipate a recovery of Eskom's performance as well as advanced repayment of its debts.

[11] FY 2017 covers a year from April 2017 to March 2018.
[12] The ceiling of the government guarantee is for 350 billion rand, and there is highly possible that the debt outstanding of the guaranteed obligations will continue to increase.
[13] The largest black residential area near Johannesburg. As it is located in the urban zone, it is not included in the local communities.
[14] The central government introduced in 2001 a basic support service of electricity to the poor residents under which the necessary power for life is provided for free. Management of the program is left to each municipality, which buys the power from Eskom and sells it to each household and collect the bills. However, the payment of the bills has been overdue. The CFO of Eskom told at an interview that unpaid energy bills of municipalities and Soweto combined have been rising by R500 million each month, reaching in February 2019 R18 billion for municipalities (R13.6 billion at the end of 2017) and R17 billion for Soweto. Although Eskom has taken measures like introducing prepaid meters in some districts, they have not offered a fundamental solution.

The government has shown its willingness to support Eskom thoroughly after it announced in February its support plan of R69 billion over the coming three years as a restructuring plan for Eskom's subdivision (Figure 12).

As the liquidity of Eskom became tight in April because the release of a loan (R7 billion) from the Chinese Development Bank was delayed[15] and bridging loans were denied by the public financial institutions[16], the government executed ahead of schedule the fiscal support of R17.65 billion out of three year plan of R69 billion it had decided in February.

Under such circumstances, Moody's, the only credit rating agency among the three major rating agencies that gives an investment grade to the South African government bonds, announced in its May report that it added the government guaranteed Eskom obligations to the public debt outstanding. It also pointed out that there is a possibility that the public debt outstanding will exceed 70% of GDP in several years as the economic growth is expected to remain sluggish.

The president expressed in his policy statement he gave in June his willingness to support Eskom over a long period of time, saying that the government is willing to expand the three year loan to Eskom to R230 billion loan for coming 10 years[17]. In addition, he revealed that the government is planning to appoint the successor to the Chief Executive Officer (CEO) of Eskom who expressed his resignation in May on health grounds and a newly established Chief Restructuring Officer (CRO)[18].

However, the fund shortage of Eskom continued and on July 23, the government expressed by presenting a revised FY2019 Appropriation Bill and a Special Appropriation Bill its additional financial support of R26 billion (about 0.8% of GDP) for FY2019 and R33 billion (about 1% of GDP) for FY2020. Finance Minister Mboweni said that there is a preliminary indication that tax revenue could be significantly lower than budgeted for in the 2019 Budget and the government debt would also be likely to increase due to the financial support to Eskom.

Under these circumstances, the rating agency Fitch downgraded its rating outlook to

[15] Finance Minister Mboweni said that the delay in releasing the funds was due to Chinese exchange control requirements. Some media reported that China delayed the execution of the loan due to fear over the progress of Kusile power plant being constructed with the support of the China Development Bank.
https://www.fin24.com/Economy/Eskom/eskoms-china-loan-facility-not-in-jeopardy-public-enterprises-20190503

[16] Corporation for Public Deposits
https://nationalgovernment.co.za/units/view/408/corporation-for-public-deposits

[17] It seems the three year support plan of R69 billion was changed to the support plan of R230 billion for 10 year.
https://www.gov.za/speeches/2SONA2019

[18] In charge of managing incomes, debts and expenditures of Eskom to restructure it. Finance Minister Mboweni said its appointment will be made in a few weeks by him.

"negative" from "stable" for South Africa. Moody's warned that the additional financial support would increase fiscal expenditures, negatively affecting the creditworthiness of South Africa. Moody's pointed out that the lack of strategy to reduce the necessity of government support to Eskom and recover its stable conditions has worsened the fiscal problems of the government and presented a view that, without a clear reconstruction plan, additional supports would become necessary. In the worst scenario, it said, the fiscal deficit may increase to 5.7% of GDP in 2019 and 5.6% of GDP in 2020, accelerating the expansion of the public debt.

However, Moody's also commented that although the government's room to manoeuvre was 'extremely constrained', the government will take additional measures for revenues and expenditures in its Medium Term Budget Policy Statement (MTBPS) to be presented in October. Moody's is likely to wait for the action of the government before it changes the rating assessment.

An analyst at BNP Paribas has said that, although the current support measures provide a short-term liquidity to Eskom, it is a problem that long-term funding program and concrete restructuring plan of Eskom have not been shown yet. In addition to the financial difficulty, Eskom has such structural problems as surplus workers[19] and a strong labor union[20]. Going forward, newly appointed CRO Mr. Freeman (CEO of South African Institute of Chartered Accountants) and his team are required to present a restructuring plan backed by a clear roadmap, and steadily implement it[21].

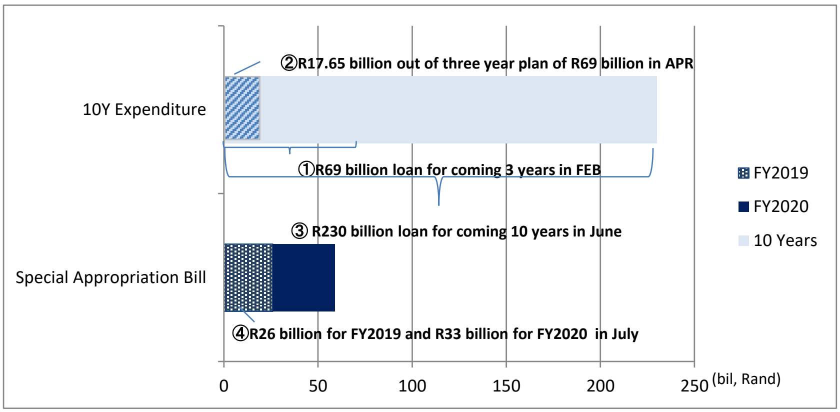
Table 2: Business Performance of Eskom (in Billion Rand)

FY	2013	2014	2015	2016	2017	2018
Sales	138	148	164	177	177	180
Current net income	7	0	5	1	-2	-21
Debt	261	303	328	367	399	441
Guaranteed by the government	125	150	175	203	245	273
Local municipalities		5	6	9	14	20

（Source）(Financial Statement of) Eskom

[19] Eskom itself expresses 16,000 workers out of its 48,000 workforce are excess, and the World Bank has said two thirds of the workforce is redundant.
[20] The labor union often demands wage increases, and when Eskom rejects their demand or cuts jobs, it counters with strikes and sabotages. For this reason, it is not easy for Eskom to negotiate a wage cut of employees aiming at its restructuring.
[21] According to some media, Eskom plans to go on a non-deal road show to render its account in August and there is a possibility that a concrete plan will be disclosed at that time.

Figure 12　Government Financial Support to Eskom



（Source）Various reorts

5. Resilience to external shocks

（1）Developments of Balance of payments

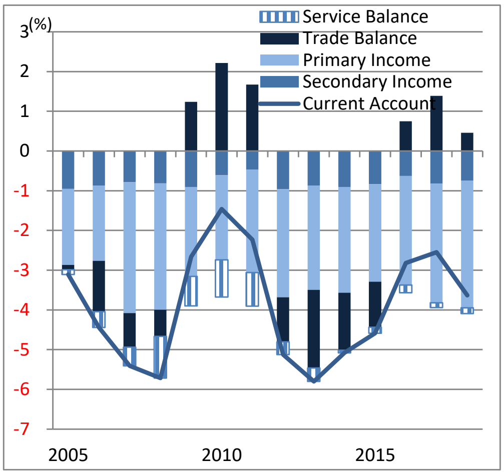
The current account has been constantly in red against the backdrop of a large deficit of the income account (payments of portfolio investment income, repatriation of direct investment income, etc.), while the trade balance becoming a key factor for the change in the current account deficits (Figure 13). While exports of minerals and precious metals increased with the recovery of resource prices since 2017(Figure 15), imports of crude oil increased at a faster pace, worsening the current account deficit to 3.6% of GDP in 2018. The current account deficit is expected to remain at above 3% in 2019 as the exports will continue to grow at a sluggish pace due to stalled supply reflecting stagnant investment, in addition to the falling price of coal responding to a slowdown of Chinese demand. However, the World Bank forecasts in its outlook of international commodity prices that the resource prices except energy will slowly recover after 2020, which suggests a low possibility that the current account deficit of South Africa will worsen as significantly as it did at the time of large drop of resource prices around 2014. The British research institute forecasts the current account deficit will remain within a narrow range of 3.2% to 3.7% of GDP in 2019-2023[22].

In the financial account, the foreign acquisition (capital inflow) of assets in South Africa continues to exceed the acquisition of foreign assets by South African capital (capital outflow).

[22] The SARB forecasted the current account deficits of 3.3% of GDP for 2019, 3.4% for 2020, 3.5% for 2021 in its financial review for April.

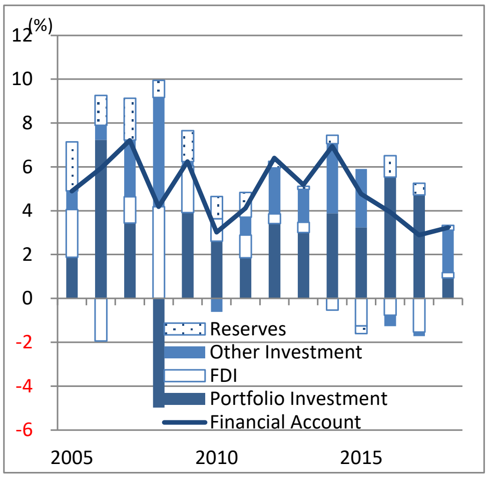
However, it should be noted that South Africa has a vulnerability to capital flight as the capital inflow has been in the form of volatile portfolio and other investment while foreign direct investment remains sluggish (Figure 14).

Figure 13: Current Account (% of GDP)



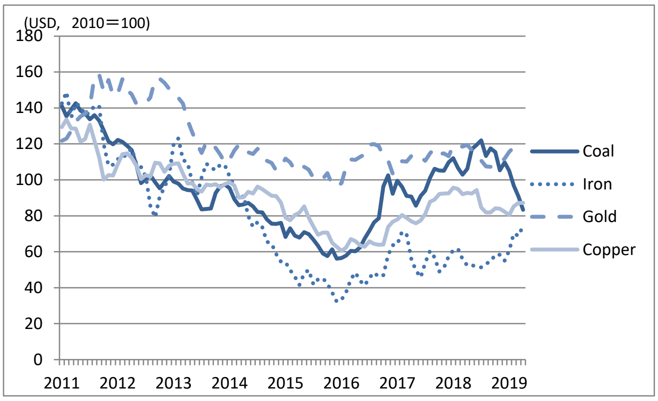
(Source) IMF

Figure 14: Financial Account (% of GDP)



(Source) IMF

Figure 15: International Commodity Prices for Major Export Items



(Source) WB

(2) Risks to external debts

External debts of South Africa decreased to 46.8% of GDP in 2018 from 49.6% in 2017[23](Figure 16). Also the share of external debts denominated in local currency remains at around 50%, a relatively high level for emerging economies, which Moody's has evaluated as a

23 In addition to the reappraisal of rand denominated bonds, depreciation of the rand led to a decrease in the amount of rand denominated bonds.

factor to lower the external vulnerability (Figure 17). International reserves[24] remain above 6 month of imports, standing at $48.3 billion as of May 2019 although they were by 2.8 billion lower than a year ago. The ratio of short-term debt outstanding to international reserves stood at 71.4% at the end of 2018, much below 100% (Figure 18).

The repayment schedule of foreign-currency debts shows a diversified period of redemption. The largest amount of foreign exchange payment is for the repayment of $9.2 billion for 2020, which is far below the reserves of $48.3 billion as of May 2019 (Figure 19).

Meanwhile, according to the IMF, the ratio of South Africa's international reserve level to its Assessing Reserve Adequacy (ARA) [25] metric remained at 62% in 2017, far below the bound of 100 to 150% which is considered adequate. In the background, it was likely affected by the public bonds (mainly government bonds) targeted to foreign investors which had increased year by year to reach nearly 40% of the entire external debts (Figure 18). As the majority holders of the public bonds are private investors, a risk for a turmoil of financial markets should be taken into consideration once a capital flight should happen.

The IMF has pointed out the possibility of a capital outflow of $1.5 billion (about 0.5% of 2018 GDP) in case Moody's degrades the government bonds of South Africa to below investment/speculative grade and the bonds are excluded from the WGBI（Citigroup World Government Bond Index）[26]. Also a report in March 2019[27] said that Nomura Securities forecasted an outflow of investment funds of $1.1 billion and Investec Securities forecasted $8-10 billion (about 2.2% of 2018 GDP). However, it is hard to think that such capital outflows will directly lead to a fear of default on external debts since these amounts are lower than the official reserves and the net international investment position continues to record net excess of assets over liabilities with the net assets outstanding at more than 20% of GDP at the end of 2018.

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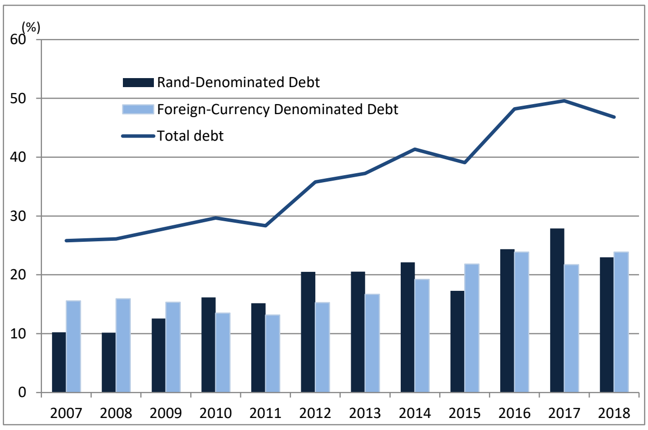
[24] South Africa has no plan to intervene in the exchange market to stabilize the currency as the local currency market has a large size as compared to foreign exchange reserves. The change in the international reserves is limited to those in deposit and payment of foreign currencies associated with issues and redemptions of foreign currency denominated government bonds, receipts of profits from foreign currency investment, and valuation changes of the dollar-denominated assets.

[25] ARA is an indicator developed to assess the adequate level of the reserves that the IMF set for emerging economies. It is calculated by the aggregated values of 5% of exports+5% of broad money +30% of short-term debts+15% of other debts as compared to the actual reserve outstanding. Reserves within 100-150 percent of the ARA metric are considered adequate.

[26] Selected Issues, IMF, July 2018

[27] Bloomberg report of March 2019
https://www.businesslive.co.za/bd/economy/2019-03-25-economists-try-to-guess-moodys-mood-ahead-of-decision-on-sa/

Figure 16: External Debts by currency (% of GDP)



（Source） SARB

Figure 17: Domestic Currency Debts of Emerging Economies

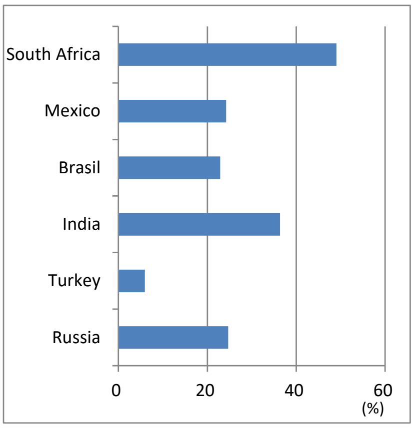
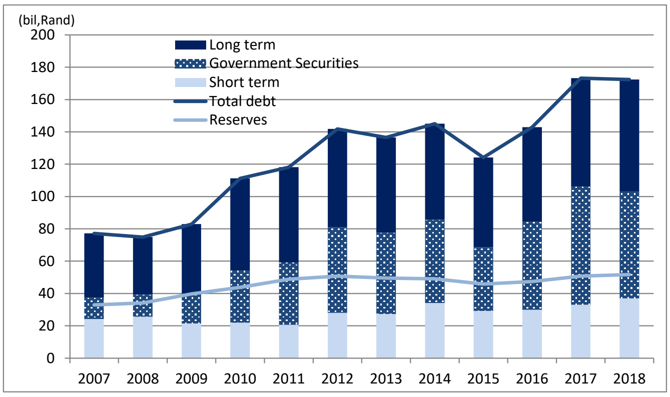


Figure 18: External Debts by term and Reserves



（Source） SARB

Table 3: Foreign Currency Debts by Maturity ($ billion)

	Short term	2019	2020	2021	2022	2023	2024	After 2025	Total
Bond	0	2	3	2	4	2	3	14	31
Others	27	5	6	3	3	3	1	9	57
Total	27	7	9	6	7	5	4	23	88

（Source） SARB Note : as of end-2018

6. Future Risk Factors

Judging from the above, the following risks may be expected to occur in the future.

・Increase of fiscal burden due to a delayed restructuring plan for Eskom

・Increase of capital outflows in response to Moody's downgrading of long-term foreign currency bonds

・Opaqueness of economic structural reforms by the Ramaphosa administration

・Prolonged slow growth

Since 2018 when the Ramaphosa administration took the office, there had been no change in the ratings by the three major rating agencies until Fitch changed the outlook from "stable" to "negative" responding to the decision of additional financial support to Eskom taken by the government in July. While Moody's did not change its rating grade or its outlook, it commented that the South Africa's creditworthiness is negative (Table 4).

Moody's is the only rating agency among the three major agencies that keeps the investment grade on South Africa, and if Moody's downgrades South Africa to speculative grade, it will lead to an exclusion of South Africa from WGBI and raise a risk for an increase of the current account deficits and depreciation of the rand against the dollar through the reverse flow of portfolio investment and other investment that have underpinned the South Africa's balance of payments. According to media reports, Moody's plans to make the next regular review of ratings on November 1, and it should be carefully watched whether the agency downgrades its rating of South Africa or changes its outlook at that occasion.

As factors for downgrading, Moody's has pointed out such developments as expansion of government debts and contingency obligations and low economic growth over the medium term, as well as cases where the government fails to pursue policies to prevent deterioration of fiscal and economic conditions and where the resiliency of the market to financial shocks weakens.

First, whether the policies to prevent fiscal deterioration will be pursued or not should be closely monitored as a risk to be materialized in the short term. As Moody's assesses the R59-billion support for Eskom as "credit negative", it will become the key whether the government can present concrete plan that will lead to an improvement of Eskom's business performance, controlling further expansion of fiscal burdens. On this point the views of experts are mixed. Some analysts see it is unlikely that the government will take any meaningful policies to halt a fiscal deficit or expansion of public debts by the time of Moody's regular review in November, thus increasing a risk of downgrading. On the other hand, an analyst at the Barclays, a private financial institution, says that the government is unlikely to pursue policies that will directly lead to a downgrading[28] and it will be able to reassure the ratings agencies to

[28] Finance Minister Mboweni suggested on the occasion of announcement of additional support of Eskom that he expects the CRO of Eskom soon to be appointed will hear the opinions from the rating agencies on the policy

some extent if it can present reforms targeting for economic stimulus in the MTBPS. So there will be room to avoid the downgrading depending on the response of the government[29].

While the Ramaphosa administration has already undertaken the reforms to boost the sluggish economic growth, it is hard to assess the effects in a short time, which lowers the possibility for an immediate downgrading. However, the economy remains in an unstable condition, and the Ramaphosa administration does not hold a firm support base both within the party and outside of the party[30], which makes it unclear whether the administration can continue to pursue over the medium- and long-term the economic reforms that cannot gain the support of the people. Unless the economic reforms are not promoted, improvement of business circumstances cannot be expected and it is hard to attract foreign direct investment. Under such circumstances, it should be noted that there is a risk for a prolonged low growth of the economy as it will become difficult to promote diversification and sophistication of industries and create enough employment to lower unemployment rate.

Meanwhile, it is less likely the country will rapidly come to face financial shocks, since the SARB is conducting a sound monetary policy management and the vulnerability to external shocks is low supported by the low ratio of foreign currency debts in the entire external obligations, flexibility of foreign exchange rate, and ample international reserves.

Table 4　Assessment of Three Rating Agencies

	S&P	Moody's	Fitch
Rating	BB	Baa3	BB+
Outlook	Stable	Stable	Negative
Date	APR 2017	JUN 2017	NOV 2017

（Source）Each agency announcements available by July 2019

measures for solution of Eskom debt problem and reconstruction of its management and then propose realistic measures.

29 An analyst at BNP Paribas comments that Moody's is highly likely to downgrade its outlook of South Africa to negative, but do not downgrade its rating to below-investment grade in 2019.

30 In addition to appointing competent ministers for economic reforms, President Ramaphosa formed a cabinet while keeping balance among party factions, therefore the risk of destabilized domestic politics is low in the short term including a party split within the ANC party.

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