national treasury
Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

SOUTH AFRICAN RESERVE BANK

Pretoria, South Africa
July 15, 2020

Ms. Kristalina Georgieva
Managing Director
International Monetary Fund (IMF)
Washington, D.C. 20431

Dear Ms. Georgieva,

1. On behalf of the Government of South Africa, we hereby request approval of financial support from the IMF under the Rapid Financing Instrument (RFI) in an amount of SDR 3,051.2 million (100 percent of quota) to mitigate the adverse economic impact of Covid-19. We request that, upon approval by the IMF's Executive Board, the full amount be made immediately available to the National Treasury account at the South African Reserve Bank (SARB) as budget support.

2. South Africa has been hit hard by Covid-19. With its rapid spread and the adverse economic impact of a strict lockdown, the economy is under severe stress. Preliminary data show a marked decline in economic activity during the lockdown, with a nascent recovery underway. We expect output to fall drastically in 2020 and take more than three years to recover to pre-crisis levels. Unemployment will exceed 30 percent. Formal sector job losses are expected to exceed one million.

3. Prolonged weakness in the South African economy would have negative spillovers to the sub-Saharan African region, in particular in the southern part of the continent. South Africa remains a key contributor to the region's GDP. Trade in goods and services and remittances from regional workers employed in South Africa would also be at risk. At the same time, a drag in South Africa's investments in neighboring economies would jeopardize regional integration.

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4. The crisis has adversely affected domestic market liquidity conditions and financial asset prices amid global market turmoil and fears that the pandemic would weigh heavily on growth and public finances. The country experienced sizable portfolio outflows in March, both in absolute terms and relative to emerging market peers. The sovereign credit downgrade by Moody's at end-March, which led to South Africa's exclusion from the World Government Bond Index, further exacerbated losses. These developments contributed to a significant depreciation of the rand, which fell more than 30 percent against the US dollar this year through early-April. The real effective exchange rate declined 16 percent in the first five months of 2020, one of the largest depreciations among large, liquid emerging markets. Domestic bond market yields rose sharply. Despite portfolio flows having broadly stabilized since May, valuations of domestic financial assets, including the exchange rate, remain weak, resulting in challenging financing conditions for the public and private sectors.

5. We decided to implement a strong relief package amounting to R500 billion or more than 10 percent of GDP in response to the crisis. It is part of a set of interventions divided into three phases. In the first phase, we have reprioritized disaster relief already allocated in the budget towards the health sector; phase two relates to the fiscal support package; while the third phase will take place over the medium term and will be directed toward structural reforms to achieve higher and more durable economic growth. Given the profound uncertainty around the evolution of the pandemic and health-related conditions, it is likely that these phases will overlap.

6. As part of the relief package, we are implementing measures that include support to vulnerable groups through six-month top-ups of social security grants, food security, and other forms of distress relief; temporary employment relief support through the unemployment insurance fund; additions to health services; funding for municipal services such as cleaning, sanitizing and provision of clean water to poor and rural communities; school sanitization and preparedness; support to small businesses and workers and to critical public entities; and tax deferral measures and payment holidays. We have also launched a credit guarantee scheme for small and medium-sized firms. The scheme will be implemented in phases, over a minimum of 2 years. The SARB will provide the initial funding, but the fiscus will ultimately backstop and guarantee credits for an initial amount of R100 billion, up to a limit of R200 billion.

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7. The direct impact of the fiscal package on the consolidated budget amounts to R185 billion while R101 billion of existing expenditure commitments will be reprioritized and shifted towards Covid-19-related interventions. The rest of the spending will be financed through the use of cash balances and borrowing from multilateral institutions (around US$7–7.5 billion).

8. The SARB has progressively cut the policy rate and provided liquidity to the financial sector and domestic markets. The Monetary Policy Committee (MPC) has cut rates by 275 basis points so far in 2020, taking the repo rate to 3.75 percent, its lowest level on record. In real terms, the policy rate is now negative, and well below the estimated real neutral rate of about 2 percent. In addition, the SARB has sought to support financial market functioning by: (1) expanding liquidity provision to banks through new lending facilities; (2) providing finance for the credit-guarantee scheme to support SMEs; (3) purchasing government bonds on the secondary market to ensure orderly market functioning; and (4) releasing capital buffers and relaxing provisioning requirements for banks, to keep credit flowing to the real economy.

9. Despite these efforts, GDP is projected to contract by over 7 percent in 2020. The growth projection is premised on a gradual relaxation of the restrictions associated with the lockdown. The peak in the infection rate is expected for end of 2020Q3, while the steepest economic contraction is forecast to occur in 2020Q2. Even after the relaxation of lockdown restrictions, the recovery of investment, exports and imports is expected to be gradual. Growth is forecast at 2.6 percent and 1.5 percent in 2021 and 2022, respectively.

10. Notwithstanding the sharp depreciation of the rand against the US dollar since January, inflationary pressures are projected to remain well contained given the widening negative output gap, weak wage pressures, and lower oil prices. Annual average headline CPI inflation is consequently expected to gradually return to the midpoint of the target band during 2020–22.

11. As a result of Covid-19-related pressures on the budget, the external position is under stress. Despite import compression, the current account deficit is projected to be around 1.8 percent of GDP in 2020 due to large net income payments. However, with the increase in capital outflows, higher financing costs, and additional spending required to support households and firms through the crisis, the government borrowing needs over the upcoming months will be substantial. While exchange rate flexibility helps mitigate balance of payments pressures, a temporary external financing need of about

US$10.5 billion is likely to emerge in 2020. We intend to cover this need through the use of reserves and financing from IFIs, including the African Development Bank, the BRICS New Development Bank, the IMF and the World Bank.

12. Covid-19 has put significant pressure on the budget. The FY2020/21 budget deficit was 6.8 percent of GDP. However, the large economic downturn has led to substantial revisions of the fiscal indicators. Our estimates indicate that revenue will be lower by around R304 billion (or 6.3 percent of GDP) compared to the budget. Given that immediate spending adjustments are not prudent in the midst of a deep recession, the massive revenue losses, alongside the stimulus spending, imply that the national government deficit is now estimated at around 14.6 percent of GDP in FY2020/21. In addition to financing this deficit, the government may face increasing contingent liabilities, mainly from deteriorating finances in state-owned enterprises (SOEs).

13. The supplementary budget review submitted to parliament on June 24, 2020 sought approval of the Covid-19 relief package. This budget presented a medium-term stabilization scenario that will be the basis for the October Medium-Term Budget Policy Statement (MTBPS) baseline projections. This scenario reflects our decision to implement the needed measures to achieve debt stabilization. To this end not only will the temporary relief measures be phased out as the pandemic wanes, but some of the expenditure cuts implemented to make room for the relief measures will either become permanent or be replaced by other cuts.

14. From FY2021/22 onwards, once the impact of the pandemic subsides, we will take action to reverse the upward trajectory of the public debt-to GDP ratio. To facilitate this effort, we are open to introducing a debt ceiling in addition to the nominal spending ceiling currently in place. The October MTBPS and the process leading up to the February 2021 budget will propose fiscal consolidation measures that will allow public debt to decline after peaking at 87.4 percent of GDP in FY2023/24. The implementation of zero-based budgeting for national and provincial departments will reduce dependency on previous budgets and pursue a better alignment between revenue and expenditure. We intend to take measures that include further reductions in the wage-to GDP ratio, rationalization of transfers to SOEs, and streamlining of subsidies. The reform package seeks to place expenditure levels on a more sustainable footing while improving its composition. On the revenue side, we intend to help revenue recover by strengthening enforcement to enhance tax compliance, alongside other

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revenue measures. Moreover, our support to SOEs will be strictly conditional on meeting key performance indicators to improve their operational and financial health so as to reduce its need over time. This process has been initiated with Eskom and will be extended to all SOEs.

15. The SARB will preserve its inflation objective and aim to anchor inflation expectations around the mid-point of the 3-6 percent target range. Based on the underlying economic conditions, there will be adjustments in the policy stance to ensure inflation does not accelerate above the 4.5 percent midpoint of the target range on a sustained basis. The SARB's active balance sheet policies will be unwound over time, in line with the planned transition of the monetary policy implementation framework, which was premised on a money market liquidity shortage before the crisis. The SARB will also ensure soundness of the financial system. Bank regulatory allowances will be reversed, in time, as conditions normalize. SARB measures have been conceived as temporary interventions for a crisis, which will be most intense this year and fade over the medium term.

16. In addition to fiscal consolidation, debt stabilization will require removing structural constraints to growth. To this end, we will implement reforms as articulated in our document entitled *Economic Transformation, Inclusive Growth, and Competitiveness: Towards an Economic Strategy for South Africa. These reforms* focus on (1) modernizing and reforming network industries (such as electricity, road, rail, ports and telecommunications) so that lower costs and increased efficiency can improve business competitiveness; (2) re-orienting trade policies and pursuing greater regional integration to boost exports, employment and innovation; (3) lowering barriers to entry to make it easier for businesses to start, grow, and compete; and (4) supporting labor-intensive sectors such as tourism and agriculture to achieve more inclusive growth.

17. Addressing Eskom's problems is key to restoring reliable electricity supply, building confidence, and lessening the burden on the fiscus. In the near-term the focus is on: (1) improving the fleet's efficiency to reduce risks of load shedding; (2) stabilizing Eskom's financial situation by spending wisely on procurement and compensation and enhancing revenue collection from municipalities; and (3) continuing to encourage private sector participation in the sector. The planned unbundling will enable greater efficiencies in the electricity sector and reduce fiscal risk posed by Eskom.

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18. Given that Covid-19 has destroyed some productive capacity, deep reforms are needed in product markets to remove barriers to domestic and foreign investment, followed by reforms to support job-rich growth. South African firms need to innovate, move to greener technologies, raise productivity, and seek out export markets. We intend to encourage firm entry to improve competition; leverage public-private partnerships in a fiscally responsible way to boost market access; and reduce regulatory obstacles to investment in all sectors. We intend to raise employment-creation by revamping the skills framework, giving firms greater ability to hire labor and undertaking education reforms to make it easier for first time workers to find a job.

19. On governance, meaningful reforms are being implemented in the South African Revenue Service, the Public Investment Corporation, and other institutions. New leadership has been appointed in various public entities; policies and procedures are being reviewed; and prosecution agencies have been given additional capacity to investigate and hold wrong-doers accountable. New procurement legislation, aimed at consolidating rules and management of the public procurement system within one framework, is set to be presented to parliament during the current fiscal year.

20. South Africa does not have outstanding credit from the IMF and its capacity to repay the RFI purchase is adequate. We intend to meet our financial obligations to the IMF on a timely basis. External and public debt sustainability indicators will not change significantly as a result of the RFI purchase, and we will take any necessary measures to maintain debt sustainability.

21. The SARB will undergo a safeguards assessment as soon as feasible. We will provide Fund staff with the SARB's audit reports and authorize IMF staff to engage with external auditors as needed. We have put in place a memorandum of understanding between the SARB and the National Treasury that clarifies the responsibilities for timely servicing of the financial obligations to the IMF.

22. Moreover, in line with the Public Financial Management Act, we are committed to transparently plan, use, monitor and report all Covid-19 related spending to ensure it reaches the targeted objectives, by: (1) publishing on a regular basis the execution of Covid-19-related expenditures, auditing such expenditure, including ex-post valuation of delivery, within 12 months of the end of the fiscal year, to be performed by the Auditor General and publishing the findings; and

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(2) publicly disseminating all Covid-19-related procurement contracts and allocation (with details about awarded companies and their beneficial owners).

23. We do not intend to introduce or intensify exchange and trade restrictions and other measures or policies that would compound South Africa's balance of payments difficulties.

24. We agree to the publication of all the documents submitted to the Executive Board in relation to this request.

Sincerely yours,

Tito Titus Mboweni
Minister of Finance

Lesetja Kganyago
Governor, South African Reserve Bank