Emerging market insights

Is South Africa the next Brazil?

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South Africa bears increasingly striking similarities – in a bad way – to Brazil. Just a few years ago both were considered first-tier emerging market economies personified by their inclusion into the BRICS acronym. The BRICS – Brazil, Russia, India, China and South Africa – were regarded as countries that were leading the way in terms of rising and future consumer demand. This narrative has changed. BRICS is now a two-speed club.

While China and India's growth remains very robust driven increasingly by consumer spending, services and innovation, the economies of Brazil, Russia and South Africa are stuck. Their economic headwinds are largely self-caused and compounded by poor politics and lethargic governments that are unwilling to carry out long overdue structural reforms. Ultimately the emerging market story is a governance story.

We are all considering the future of the South African economy. Its outlook is dependent on the political outcomes of the upcoming ANC National Conference in December. If political change results in politicians who are willing and capable of driving structural reform, the South African economy will see slow but sure recovery.

If the status quo continues, the economy is likely to face further ratings downgrades with potential for a sharp and severe contraction, Brazil-style.

Already mired in recession, there is very little that resembles a true willingness to reform and adopt a real growth plan from the current ANC-led Government. The consensus among international organisations such as the International Monetary Fund (IMF) and the World Bank is that South Africa will see slightly positive growth this year, but very little beyond the paltry 0.3% recorded in 2016.

Population growth currently stands at 1.6%. Thus on a per capita income basis, as population growth exceeds GDP growth, South Africans are in fact becoming poorer.

However, there is a valid argument that these already-low forecasts for this year are too optimistic, given the economy’s contraction in the first quarter of 2017, business confidence plummeting to lows last seen during the global financial crisis, and the purchasing managers’ index (PMI) once again in contractionary territory.

Should the current trend continue, and the ANC fail to adequately address its governance shortcomings, is there a likelihood that South Africa is the next Brazil?

It is difficult to comprehend that South Africa is setting itself up to follow Brazil’s bad example. Prior to the positive growth recorded in the first quarter of 2017, the Brazilian economy experienced eight consecutive quarters (two years!) of negative growth, was downgraded to sub-investment grade (and stayed there), and experienced continuous scandals. Brazil’s economy shrunk by 3.6% last year.

Figure 1. Real GDP growth (% change, q-o-q, SAAR), Q1 2012 – Q1 2017

There are stark similarities between the two countries that could well see South Africa track Brazil’s self-induced downward growth spiral.
According to Transparency International’s 2016 Corruption Perception Index, South Africa and Brazil both rank poorly in 64th and 77th position respectively. However, despite Brazil’s dismal ranking, the country’s judicial system at least continues to function.

Former Brazilian president, Luiz Inácio Lula da Silva (popularly known as Lula), of the left-wing Workers Party was found guilty in July of accepting some US$1.2m in bribes and sentenced to nine-and-a-half years in prison.

Similarly, Dilma Vana Rousseff, his successor, was impeached in August 2016 on charges that she unlawfully allowed loans from state-owned banks to the Treasury thus creating an artificial budget surplus which was not the case.

There is a widespread view that following a massive corruption scandal centring around the state-owned oil company Petrobras that there are almost no clean politicians in Brazil. The current president, Michel Temer, is likely to suffer the same fate.

Given the worrying similarities between the leadership of both countries, South Africa could potentially follow in Brazil’s economic footsteps, albeit with an approximate two-year time lag. Brazil’s structural weaknesses were exposed following the collapse in commodity prices – especially iron ore and oil – from 2013. By 2015, the economy had contracted 3.8%, the worst decline in over two decades.

There are already several worrisome indicators developing that show South Africa tracking the South American country. To the great dismay of South Africans, sovereign debt rating downgrades were issued by all three international rating agencies earlier this year.

Two of the agencies, S&P Global Ratings and Fitch Ratings, now rate South Africa in sub-investment grade territory. Brazil was downgraded to ‘junk status’ in 2015, and has subsequently failed to regain investment grade status, instead being downgraded further.

Looking at the factors behind Brazil’s multiple downgrades to sub-investment grade within two years, the primary reason relates to the country’s worsening fiscal situation. Brazil’s fiscal deficit widened sharply from 2.3% of GDP in 2012 to over 10% of GDP by 2015. Furthermore, Ms Rouseff’s government failed to adequately implement fiscal reforms which resulted in S&P’s downgrade to ‘BB+’ in September 2015. Fitch Ratings swiftly followed suit with a downgrade to junk status and Moody’s doing the same in 2016.

**Figure 2. Long-term foreign currency sovereign debt rating, 2005-17**

Ongoing corruption scandals, political turbulence and extended negative growth were also cited by the rating agencies as reasons for Brazil’s sub-investment ratings. Brazil is now currently rated two notches below investment grade by all three rating agencies.

**Figure 3. Fiscal deficit (% of GDP), 2008-16**

Source: Fitch; Moody’s; S&P, 2017

*Note: Graphic illustrates the worst rating of the three ratings agencies for each country.*

Source: Trading Economics, 2017
In turn, South Africa’s downgrades have stemmed from concerns over governance of state-owned enterprises (SOEs), a rise in risks to policy continuity, little to no growth and slowing fiscal consolidation. S&P stated that state liabilities (particularly due to Eskom’s precarious financial status) are set to rise, while the rating agency also assumes a higher risk of fiscal wastage. Eskom’s government-guaranteed debt amounts to some R218bn in the 2016/17 FY and accounts for almost half of all the Treasury’s guarantees.

**Figure 4. Current account deficit (% of GDP), 2008-16**

Source: China Statistical Yearbook/China National Tourism Administration/FGRT

*Note: includes non-tourists such as business travellers*

South Africa also has significant pressure stemming from its wide current account deficit. While this deficit has narrowed over the last few years, from 5.8% of GDP to 3.3% of GDP last year, it remains much wider than ideal. In comparison, Brazil’s current account deficit only amounted to 1.3% of GDP in 2016. This makes South Africa even more vulnerable to sovereign debt rating downgrades, given that the country relies heavily on FDI inflows to finance its current account deficit.

Looking ahead, pressures on South Africa’s sovereign credit rating include very weak real GDP growth, public sector underperformance, twin deficits showing a shortfall both in the fiscus and the current account, waning investor confidence (shown by reduced FDI inflows and low levels of local investment) and the continued structural challenges of high unemployment, inequality and poverty.

Unless the state can reform itself, provide greater confidence for private capital and create a greater enabling environment for business, further downgrades can be expected.

**Figure 5. Total public debt (% of GDP), 2008-16**

Source: Trading Economics, 2017

The mismanagement of SOEs has had a dramatic negative impact on both the Brazilian and South African economies due to the systemic nature of corruption bedevilling them. In June, Bloomberg reported that Brazil’s corruption investigations have so far resulted in the sentencing of “144 executives, bureaucrats and political operators to more than 1,464 years in jail”!

A new law is even being considered in Brazil that stops political parties appointing their own chums into SOEs, or at the very least, ensuring that they have the required qualifications needed for these positions. Again quoted in Bloomberg, Andre Perfeito, Chief Economist of brokerage firm Gradual Cctvm, “Brazil’s problem is not economic, its political”.

Sound familiar? It should. Unless the South African political environment is ‘fixed’ and an essential improvement in governance occurs, the country may well follow in the footsteps of Brazil, a downward spiral of economic contraction and multiple sovereign debt rating downgrades.

There is an undoubted need for urgent structural and deep reforms. Perhaps the word “structural” could best be described as “politically difficult to do” reform. Due to pervasive and damaging control of SOEs – determined most often by ideology rather than pragmatic policy – both Brazil and South Africa suffer from an overbearing state. A crisis in government has led to an economic crisis. Until the politics is fixed, there is little vision for the economy.

This article was first published in the Sunday Times in August 2017, by Dr Martyn Davies, Managing Director of Emerging Markets & Africa at Deloitte.