# South Africa budget: A Herculean task awaits

In its supplementary budget, the South African National Treasury undertook sharp revisions in the macro and fiscal framework amid the ongoing pandemic. By March 2021, government gross debt is expected to rise to 82% of GDP from 63.5% a year earlier, driven by a contraction of 7.2% in growth and a GDP fiscal deficit of 15.7%

Finance Minister Tito Mboweni delivers the budget statement, Cape Town, South Africa

Source: Shutterstock

81.8%

Gross government debt to GDP projection in FY20/21

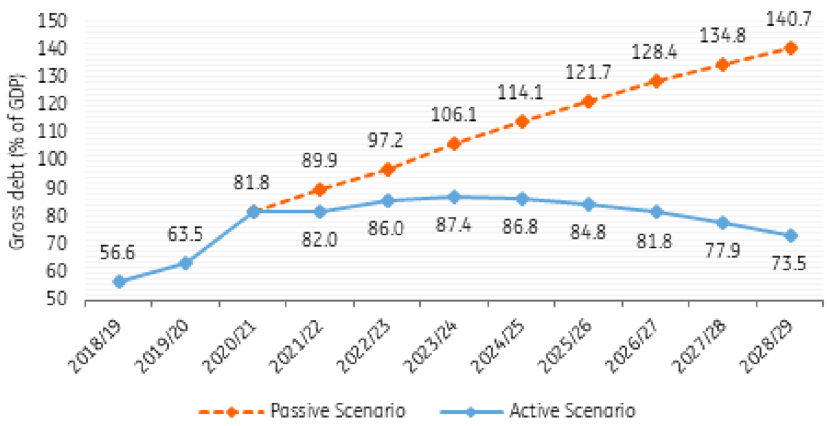
an increase by 18.3ppt vs a year earlier

## The big conundrum

The revisions for FY20/21 are mostly in line with market expectations but the big conundrum on how South Africa can stabilise its public debt trajectory remains, with the National Treasury presenting two scenarios:

The *passive scenario* is much in line with market fears of an uncontrolled debt spiral. The *active scenario* which the cabinet has endorsed would see a primary surplus and debt peaking at 87% by FY23/24. This would be achieved through tax increases, further spending adjustments and economic reforms, in addition to plans from February to tackle the public wage bill. Lastly, future fiscal frameworks would be "guided by the principles of zero-based budgeting" (where spending allocations are matched with revenues, rather than previous year's spending).

## Gross debt outlook under the NT's active vs passive scenario (% of GDP)




Source: National Treasury (Supplementary Budget Review 2020), ING

This amounts to a Herculean task by the time when Finance Minister Mboweni presents the October Medium Term Budget Policy Statement.

Some hopes rest on the government's ability to push for unpopular but much-needed reforms in unprecedented times. Ultimately, these policy choices will, however, take time and face many hurdles in a confrontational environment (namely ANC factions and unions). Meanwhile, the economic and fiscal reality paints a different and a much more dire picture. Over the next few years, debt sustainability will remain a serious concern.

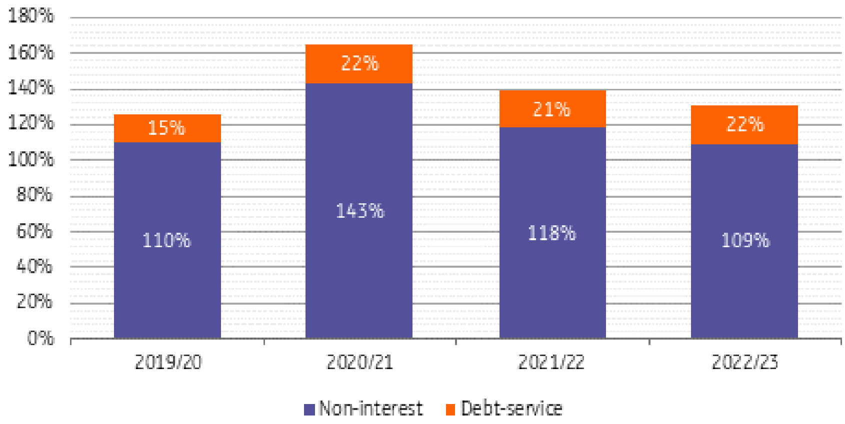
## Catching up with reality as debt/GDP surges above 80% in FY20/21

As expected, the supplementary budget marks a drastic deterioration in the fiscal outlook for FY20/21 and beyond. In comparison to the projections in the February budget, the Treasury expects the consolidated fiscal deficit to more than double from 6.8% to 15.7% of GDP for the current fiscal year.

On the one hand, revenues are affected by lower growth (seen contracting by 7.2% in 2020 before recovering by 2.6% next year) and tax revenue shortfalls, resulting in revenue as % of GDP falling to 22.6% (vs 25.8% in the February budget). On the other hand, expenditures are on the rise driven by the government's stimulus package and rising debt-service costs. For the Covid-19 relief package, ZAR145bn have been allocated in the supplementary budget which is offset by ZAR109bn from in-year spending adjustments, implying a ZAR36bn increase in expenditure.

Meanwhile, the higher debt burden and lower revenues result in a jump of debt service costs to 22% of revenues in 2020/21 (up from 15% in FY2019/20).

## Non-interest vs interest spending (% of revenues)

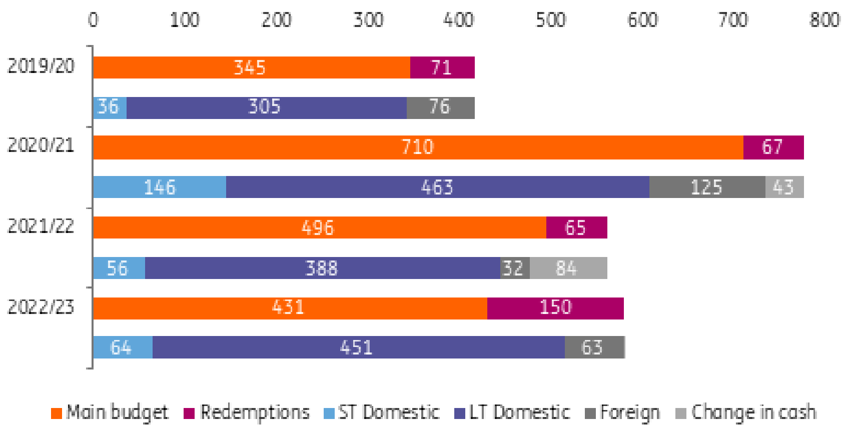



Source: National Treasury (Supplementary Budget Review 2020), ING

The substantial funding needs for the current tax year (ZAR777bn, thereof ZAR710bp for the budget deficit and ZAR67bn in redemptions) have resulted in larger domestic borrowing needs. The government focusses on short-term borrowing in the near-term (ZAR146bn for FY2020/21 vs ZAR48bn in February budget) which eases the pressure on long-term borrowing (ZAR463bn vs ZAR338bn).

Foreign funding of ZAR125bn (c.US$7bn), we believe, represents the funding sought from IFIs, including the already secured US$1bn from the New Development Bank and US$4.2bn under the IMF Rapid Financing Instrument (talks ongoing). This would mean no or only opportunistic Eurobond issuance for FY2020/21.

## Gross borrowing requirement and financing (ZARbn)




Source: National Treasury (Supplementary Budget Review 2020), ING

## Bold and unpopular reforms needed to stabilise government debt

The 15.7% of GDP deficit will see government gross debt/GDP rising from 63.5% in March 2020 to 81.8% by March 2021. The Treasury has developed two scenarios for the future debt trajectory, with the passive scenario (low growth, higher debt service and public expenditure) seeing debt/GDP steadily rising to 141% of GDP by end of the decade (see chart on front page).

The active scenario sees debt/GDP peaking at 87.4% in FY2023/24 but would require bold steps by the government, notably ZAR250bn in spending reduction over the next two years to achieve a primary surplus (vs -9.7% of GDP in FY2020/21). More details will be revealed by October, but the NT already indicated that tax increases are inevitable from next year onward (ZAR4bn in 2021/22, ZAR20bn in 2022/23, ZAR10bn in 2023/24 and ZAR15bn in 2024/25). Moreover, additional spending adjustments will be taken. In terms of economic reforms, we would be looking for plans in the MTBPS to reduce the cost of doing business and improve competitiveness. All this comes on top of the NT's ambitious target to tackle the bloated public wage bill (the February budget indicated ZAR160bn of spending reduction here) although the timeline for negotiations remains unclear while unions remain strongly opposed.

Lastly, key risks come from weak state-owned enterprises: The supplementary budget allocated ZAR3bn for the Land Bank recapitalisation but larger risks come from loss-making South African Airways and notably Eskom. The Treasury sees "the urgent need for broad-based reforms at SOEs but this has faced some roadblocks, notably with Eskom delaying its divisional split to March 2022.

## Rating pressure increases for future budget statements to deliver

Among rating agencies, Moody's said that the debt increase for FY20/21 is the highest in South Africa's rating category (Ba1 with a negative outlook) but in line with the rating agency's forecasts. However, stabilising debt by 2023 will be very difficult to achieve given the weak fiscal consolidation track record and weak medium-term economic outlook. The rating agency downgraded the sovereign rating in end-March, resulting in the loss of South Africa's last investment-grade rating and the exit from the FTSE World Government bond Index for local currency government bonds. S&P and Fitch also cut the sovereign rating by one notch each in April, to BB- and BB, respectively.

The rating remains on negative outlook at Moody's and Fitch. We believe that the National Treasury's budget has maintained a commitment to fiscal discipline by projecting a possible scenario towards debt stabilisation. Notwithstanding, increasing rating pressure will be on the October MTBPS and the February 2021 budget statement to deliver on reforms.

# Rating drivers/Factors that could lead to an upgrade or downgrade

| Agency (review date) | Upgrade Drivers | Downgrade Drivers |
| --- | --- | --- |
| **Moody's**<br>Ba1 negative<br>(20 Nov) | For outlook back to stable: **Medium-term fiscal consolidation** proceeds broadly in line with Moody's central expectations (gradual reduction in primary deficit in the next few years, with increasing assurance that government debt will stabilise comfortably below 90% of GDP), with prospects of a slow but durable pick-up in **growth** and **financing risks** remaining low | Combination of very weak growth, failure to reduce primary deficit, and rising financing costs which likely causes the **debt burden** to rise to even higher levels than projected with even greater uncertainty regarding its eventual stabilisation, in turn threatening access to funds at manageable costs (i.e. weaker institutional policymaking capacity and, over time, diminution of economic and fiscal strength consistent with lower rating levels), important indicators are:<br>• Government's ability over the next year or so to contain the **impact of global recession** on the economy and to promote recovery thereafter<br>• Implementation **of structural reforms** that would strengthen the economy<br>• Implementation of a framework for a **reliable supply of power** to the economy and **fiscal reforms** to contain expenditure and enhance revenues |
| **S&P**<br>BB- stable<br>(20 Nov) | • Credible reform efforts credibly arrest rise in **government debt-to-GDP ratio**<br>• Substantial improvement in job creation and productivity gains, leading to higher **real per capita GDP growth** | • **Economic prospects** fail to recover during forecast period and **financing pressures** mount<br>• Significant weakening of **rule of law**, **property rights**, or **enforcement of contracts** which undermines the investment and economic outlook |
| **Fitch**<br>BB negative<br>(N/A) | • Formulation of a clear and credible path towards stabilising the **government debt/GDP ratio** over the medium term<br>• Strengthening **trend GDP growth** | • Continued rise in **government debt/GDP** and failure to formulate a clear and credible path towards stabilising the government debt/GDP ratio<br>• Further deterioration in **trend GDP growth rate** |

Source: Moody's, S&P, Fitch Ratings, ING

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