

South Africa budget: Resignation or wake-up call?

The revisions in the fiscal framework without any steps to stabilise public debt appear like a resignation with regard to South Africa's fate. But on the flip side, the budget can also be seen as a much-needed wake-up call - arguably there have been many already



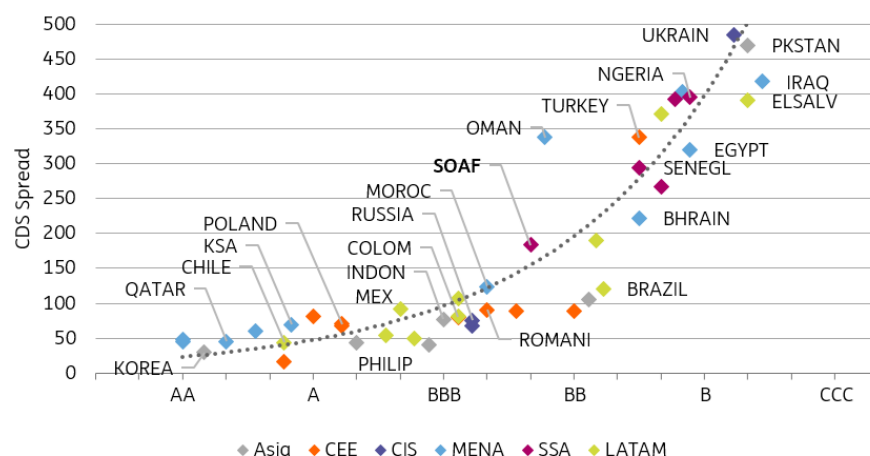
Finance Minister Tito Mboweni delivers the budget statement, Cape Town, South Africa

Source: Shutterstock

Markets are continuing to feel the repercussion from South Africa's Medium Term Budget Policy Statement (MTBPS) yesterday, with the rand having weakened by 3.2% and CDS spreads widening by 20 basis points over the last two days. Investors are retaining a cautious stance ahead of potential rating implications.

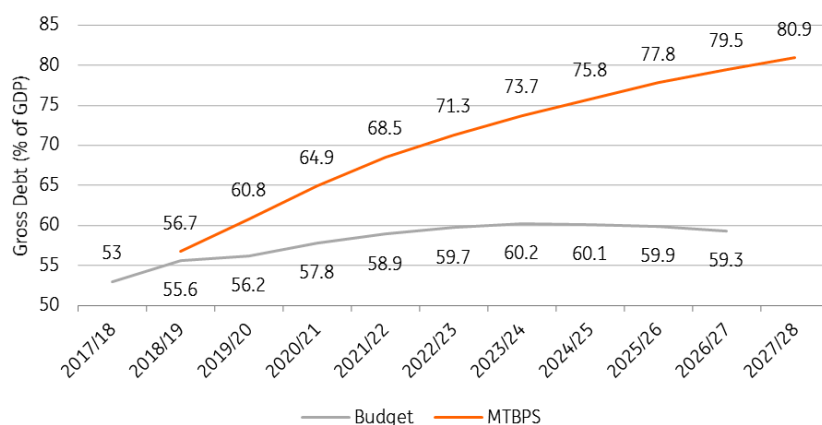
We expect a negative outlook by Moody's, although patience is likely to persist into the 2020 budget when it comes to the Baa3 rating. This cloud over the rand could prevent it from participating in any further rallies enjoyed by its high yield commodity peers and implies vulnerability to a weakening external environment.

South Africa CDS spread vs peers on a rating-adjusted basis



Source: Bloomberg, ING

February Budget vs October MTBPS: Gross debt (% of GDP)



Source: National Treasury, ING – MTBPS including financial support for Eskom

While some negativity was priced in due to a backdrop of weak growth outcomes and support measures for Eskom, the expected deterioration in the fiscal framework has come even worse as the MTBPS does not specify countermeasures (which will be specified in the 2020 budget) to offset the additional commitments and weaker revenue generation.

Most notably, the MTBPS sees the gross debt-to-GDP increasing beyond 80% over the next decade compared to February budget's forecast of a stabilisation around 60.2% in 2023/24.

February Budget vs October MTBPS: Macroeconomic projections and Fiscal framework (in %)

		2018E	2019F	2020F	2021F	2022F
Real GDP growth	Budget	0.7	1.5	1.7	2.1	
	MTBPS	0.8	0.5	1.2	1.6	1.7
CPI inflation	Budget	4.7	5.2	5.4	5.4	
	MTBPS	4.7	4.3	4.9	4.8	4.8
Current account balance (% of GDP)	Budget	-3.5	-3.4	-3.8	-4.0	
	MTBPS	-3.5	-3.4	-3.5	-3.5	-3.5

		2018/19E	2019/20F	2020/21F	2021/22F	2022/23F
Revenue (% of GDP)	Budget	28.8	29.3	29.2	29.4	
	MTBPS	29.4	29.5	29.3	29.4	29.3
Expenditure (% of GDP)	Budget	32.9	33.7	33.5	33.4	
	MTBPS	33.6	35.4	35.8	35.6	35.3
Budget balance (% of GDP)	Budget	-4.2	-4.5	-4.3	-4.0	
	MTBPS	-4.2	-5.9	-6.5	-6.2	-5.9
Gross debt (% of GDP)	Budget	55.6	56.2	57.8	58.9	59.7
	MTBPS	56.7	60.8	64.9	68.5	71.3

2018/19 2019/20 2020/21 2021/22 2022/23

Source: National Treasury, ING (Feb Budget/Oct MTBPS) – A: Actual / E: Estimate / F: Forecast

Finance Minister Mboweni highlighted that the government was looking to stabilise public debt (as a % of GDP) by 2025/26, with the 2020 budget (usually February) expected to outline measures on the public sector wage bill while tax measures are also considered (although the room seems limited here). Economic reforms are however only expected to yield results in the longer run.

With regard to Eskom, the government has topped up its planned contributions to Eskom by another ZAR10bn in 2021/22 in addition to the recently approved ZAR59bn and the ZAR69bn already included in February. However, more support is needed should Eskom find itself unable to raise debt in financial markets. Finally, the MTBPS also leaves open some debt relief on the ZAR441bn (US\$30bn) debt burden over time, contingent on improvements in operational and financial performances (expected to be completed before 2021).

All in all, we consider two possible viewpoints here: On first sight, the revisions in the fiscal framework without any steps to stabilise public debt appears like a resignation with regard to South Africa's fate. On the other hand, yesterday's MTBPS can also be seen as a much needed wake-up call (arguably there have been many already). If so, the National Treasury has achieved its objective.

Rating implications

In any case, the fiscal outlook implies an increasing likelihood for negative rating actions:

- **Fitch (BB+ neg)** was the first to react, saying that “a clear path toward debt stabilisation is still missing” and that a failure to do so over the medium term is a negative rating sensitivity. Further risks to the debt trajectory would come from a transfer of Eskom's debt onto the sovereign balance sheet, although the risk posed by contingent liabilities is reflected in the BB+ rating. Fitch revised the outlook to negative in end-July due to the “marked widening in the budget deficit” but we believe that the rating agency will wait until the February budget to see what measures the National Treasury will take. Positively, the MTBPS deficit forecast for 2019/20 (5.9% of GDP) is a touch lower than that of Fitch (6.3%).

- **Moody's (Baa3 sta)** remains the only rating agency to rate South Africa in IG territory. It is unclear whether Moody's will take a rating decision tomorrow (in line with the review schedule) but a negative outlook appears imminent. Arguably, this has been the case also on previous occasions but the MTBPS forecasts fare worse compared to Moody's estimated deficits of 5.7% and 5.6% in 2019/20 and 2020/21, respectively, under a worst-case scenario where Eskom support is not compensated for. That said, we consider a downgrade as unlikely with Moody's patience to persist into 2020. As a reminder, Moody's had placed South Africa on review for downgrade from November 2017 until March 2018 then the outlook was moved back to stable.
- **S&P (BB sta)** will be less in focus although we consider a negative outlook also as a possibility with the forecasts for growth (seen at 1.0% and 1.8% in 2019 and 2020, respectively), fiscal deficit (4.5% and 4.1% of GDP) and debt/GDP (57.4% and 58.0%) in the May summary substantially optimistic compared to those of yesterday's MTBPS. Moreover, further transfers to Eskom could be seen as a crystallisation of contingent liabilities. That said, the rating agency is likely to wait for some more clarity on potential measures on Eskom over the next week or so.

Following yesterday's MTBPS, the National Treasury is engaging with rating agencies and has also announced a non-deal roadshow with investors between 7-13 November. We also expect also further details on Eskom, with Public Enterprises Minister Gordhan saying that a new CEO will be announced over the next 10 days and that more details will be announced in the near future on options for Eskom's debt position.

Reform implementation, as we have highlighted before, remains challenging given the combination of a fractious ANC, high unionisation (amid record unemployment levels) and distractions from ongoing investigations (notably on state capture).

Wake-up call for the rand

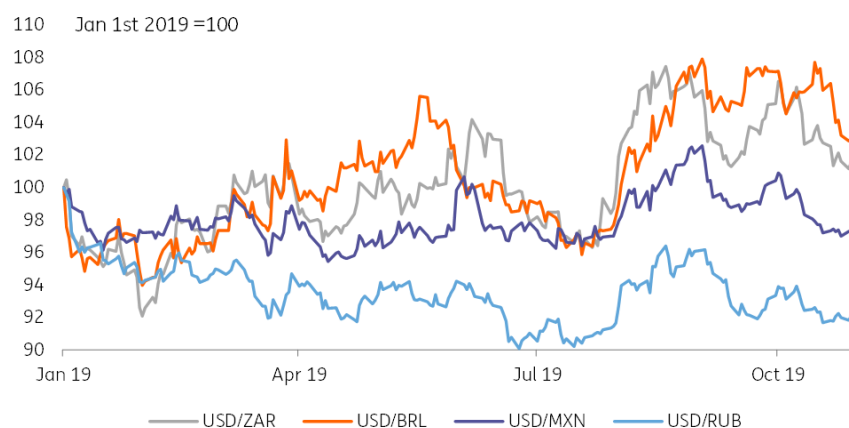
The poorly received MTBPS has also served as a wake-up call for the rand and re-awakened the fear of enforced SAGB sales, should Moody's choose to downgrade South Africa's local currency rating to junk on Friday. Recall this related to South Africa being kicked out of key investment grade bond indices such as Citi's WGBI or Barclays Global Aggregate Index. Estimates of the amount of ZAR outflows on the back of this varied anywhere between US\$1bn and US\$8bn.

While we think Moody's will hold off with the downgrade, a negative outlook could potentially merely delay the day of reckoning until next February's budget. This cloud over the ZAR could prevent it participating with any further rallies enjoyed by its high yield commodity peers, such as RUB, MXN and BRL. All of these are partly being buoyed by local currency bond inflows on the back of deep easing cycles. Like these currencies, the ZAR is also highly correlated to the China trade story, with strong co-movement with the CNH.

In our October edition of [FX Talking](#), we had a three month forecast for USD/ZAR at 15.50 - which was largely premised on a more difficult trade environment and USD/CNY trading at 7.20. In fact the external environment has been a little more benign and instead it's the domestic environment which is worse than expected.

The poor domestic story suggests the ZAR will remain increasingly vulnerable and any deterioration in the external environment could easily make USD/ZAR a 16+ story into next February's budget season.

USD/ZAR versus EM peers



Source: Bloomberg, ING

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