South Africa: Fiscal consolidation remains a distant hope

South Africa's supplementary budget tomorrow will do little to reverse the increase in the country's debt burden, which will remain a key concern for years to come. However, signalling the commitment to fiscal consolidation and credible budget revisions are crucial in attracting funding from IFIs and sustaining investor confidence

Source: Shutterstock

Lower revenues and relief package necessitate revised budget

With the onset of Covid-19, the severe lockdown put in place and the drop in external demand will all but certainly exacerbate South Africa's already weak economic and fiscal prospects. Expectations are anchored around a growth contraction of 7% for 2020 (SARB and Bloomberg consensus) and a fiscal deficit/GDP in the lower teens (Bloomberg consensus is -13.7%).

Both revenues and expenditures will be negatively affected. On the revenue side, shock scenarios in an impact assessment study by the National Treasury (NT) point to a drop between 27.0% to 32.5% vs pre-crisis levels for tax revenues. On the spending side, the NT will have to take account of the ZAR500bn (c.US$29bn) stimulus package (or c.10% of 2019's GDP), split in ZAR230bn of actual spending, ZAR70bn in tax measures and a ZAR200bn loan guarantee scheme.

Impact of Covid-19 on the South African economy

ZAR 500bn Covid-19 fiscal response package

Measures	ZARbn	Funding	ZARbn
Credit Guarantee Scheme	200	Credit Guarantee Scheme	200
Job creation and support for SME and informal business	100	Baseline reprioritisation	130
Income support (further tax deferrals, SDL holiday and ETI extension)	70	Borrowings from IFIs and development banks	95
Support to vulnerable households for 6 months	50	Additional transfers and subsidies from the social security funds	60
	40	Available funds in the Department of Social Development 202021/21 appropriation	15
Wage protection	20		
Support to municipalities	20		
Total	**500**	**Total**	**500**

Source: National Treasury, ING

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The Credit Guarantee Scheme and tax deferrals won't affect the budget at this point, while the National Treasury looks at reprioritising ZAR130bn in spending and borrowing at least ZAR95bn (c.US$5bn) from international financial institutions.

We are looking for details on funding and spending reprioritisations tomorrow

Regarding the latter, the New Development Bank's board has approved a US$1bn loan while the government is also in talks with the IMF for a US$4.2bn Rapid Financing Instrument. On the local debt market, we believe that the SARB's measures, notably through rate cuts and government bond purchases (c.0.6% of GDP so far) has been a strong supportive measure.

For tomorrow, we are looking for details on funding and spending reprioritisations. Moreover, the NT will also have to make substantial revisions to the previous macro and fiscal framework (see tables below). Bloomberg reported that Finance Minister Mboweni's presentation to the National Economic Development and Labour Council on Friday outlined debt/GDP climbing to 80.5% in FY2020/21 before rising above 100% by 2025.

Feb 2020 budget vs rating agency macro and fiscal projections (in %)

* FY figures (not fiscal year)

Macro framework		2019	2020	2021	2022
Real GDP growth (%)	Budget (Feb 20)	0.3	0.9	1.3	1.6
	Moody's (Mar 20)	0.2	-2.5	1.1	
	S&P (May 20)	0.2	-4.5	3.5	1.5
	Fitch (May 20)	0.2	-5.5	3.7	
CPI inflation (%)	Budget (Feb 20)	4.1	4.5	4.6	4.6
	Moody's (Mar 20)	4.0	4.2	4.5	
	S&P (May 20)	4.1	3.9	4.4	4.5
	Fitch (May 20)	4.1	4.5	4.5	
Current account balance (% of GDP)	Budget (Feb 20)	-3.4	-3.4	-3.5	-3.7
	Moody's (Mar 20)	-3.0	-3.8	-3.6	
	S&P (May 20)	-3.0	-0.7	-1.9	-2.5
	Fitch (May 20)	-3.0	-4.7	-4.0	

Fiscal framework		2019/20	2020/21	2021/22	2022/23
Revenue (% of GDP)	Budget (Feb 20)	29.4	29.2	29.2	29.2
	Moody's (Mar 20)	29.4	29.2	29.2	
	S&P (May 20)*	29.5	28.1	30.2	29.5
	Fitch (May 20)	29.9	29.0	29.7	
Expenditure (% of GDP)	Budget (Feb 20)	35.7	36.0	35.4	34.9
	Moody's (Mar 20)	35.9	37.7	37.7	
	S&P (May 20)*	36.3	41.4	37.9	37.3
	Fitch (May 20)	36.5	40.6	37.7	
Budget balance (% of GDP)	Budget (Feb 20)	-6.3	-6.8	-6.2	-5.7
	Moody's (Mar 20)	-6.5	-8.5	-8.4	
	S&P (May 20)*	-6.8	-13.3	-7.6	-7.8
	Fitch (May 20)	-6.6	-11.5	-8.0	
Gross debt (% of GDP)	Budget (Feb 20)	61.6	65.6	69.1	71.6
	Moody's (Mar 20)	69.3	77.6	82.6	
	S&P (May 20)*	63.7	79.9	82.2	86.0
	Fitch (May 20)	64.5	75.9	80.2	

Source: National Treasury, rating agencies, ING

Additional risks come from the weak state of state-owned enterprises, with recent headlines pointing to South African Airways' need for ZAR26.7bn (c.US$1.5bn) in government support, above the ZAR16.4bn that the government has already put aside in the February budget. On Eskom, the utility is expected to post a ZAR16bn loss in the fiscal year ending March 2020 and put off the planned split into three divisions until March 2022.

Regarding the wage bill, the February budget's key consolidation measure was expected to reduce spending by ZAR160bn (out of a total ZAR261bn). We haven't seen any progress lately but arguably, expectations for a breakthrough were already low ahead of the crisis.

Fiscal commitment key for IMF funding and sustaining confidence

The virus outbreak has taken a toll on economic and fiscal outlooks across the globe but in comparison to other larger emerging markets, South Africa's economic and fiscal trajectory had already been a large concern. Tomorrow's budget revisions won't resolve the conundrum on whether the government can turn around the growth and fiscal outlook post-Covid-19, as we don't expect major fiscal consolidation reforms tomorrow.

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The best possible outcome would see Mboweni presenting a credible plan to fund and reprioritise spending for the relief package while reiterating a strong commitment to fiscal discipline. Ahead of tomorrow's event, Mboweni had warned that South Africa could face a debt crisis by 2024 and called for the adoption of zero-based budgeting (where spending allocations are matched with revenues, rather than previous year's spending). The fiscal consolidation commitment will pave the way for access to the much needed US$4.2bn IMF RFI, which requires a country's debt to be "sustainable or on track to be sustainable".

Macro backdrop dominates short-term risk, fiscal concerns to persist

The rand, like many emerging market currencies, has made a strong comeback from the lows seen in April but is still some 18% lower against the dollar on a year-to-date basis.

Despite the speed of the ZAR recovery from 19/USD has surprised us. In April we felt investors would be more discriminating in terms of the currencies they chose to back at the early stage of the recovery cycle and now junk-rated South African assets would be spurned. But no, the flood of liquidity has seen a broad swathe of EM currencies recover.

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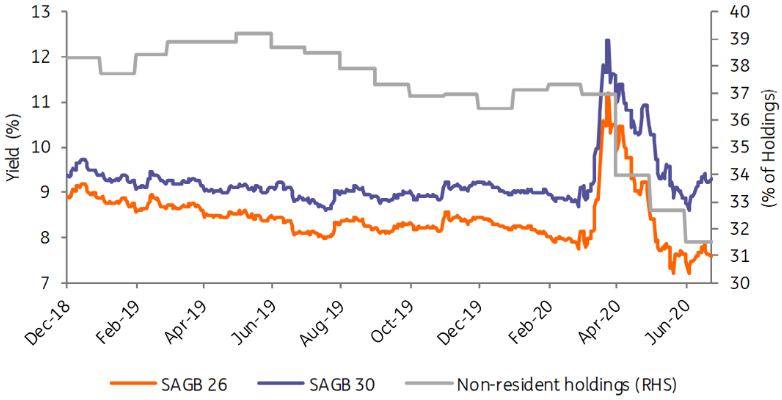
If we're right with our call for a benign dollar decline for the rest of 2020, $/ZAR could press the 16.00/16.50 area, backed by a strong external environment over budgetary concerns at this early stage in the recovery cycle. When the liquidity honeymoon is over, however, South Africa's twin deficits will leave the ZAR very exposed to any turn in sentiment.

At the height of the Covid-19 crisis, Moody's cut South Africa's rating from Baa3 to Ba1 on 27 March, with the loss of the last investment-grade rating meaning an exit from the FTSE WGBI. The crisis and the WGBI exit have seen the share of non-residents in SAGB bonds dropping 36.9% in end-February to 31.5% in end-May (see chart below). However, the SARB's cumulative 275bp in rate cuts year-to-date and decision to buy SAGBs in the secondary market has seen yields falling substantially, with SAGB 10.5% 26s (R186) trading at 7.6% (vs above 10% in end-March).

Despite, the ballooning fiscal deficit implies higher funding needs in the local debt market, with the SAGB curve remaining steep and a modest reversal in SAGB performance ahead of tomorrow's event.

SAGB 2026/2030 local currency bond yields vs share of non-resident holdings (in %)



Source: Bloomberg, ING

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