

South Africa: High fiscal consolidation commitment but weak budget viability

Last week's Medium Term Budget Policy Statement (MTBPS) served as an opportunity for the National Treasury to double down on its commitment to fiscal consolidation and deliver specifics on how to stabilise debt beyond this year. As always, commitment is the easy part but the conundrum on whether debt sustainability can be restored will stay with us



South African president Cyril Ramaphosa (C) dances with Minister of Education, Naledi Pandor (R) and ANC Western Cape provincial election leader Ebrahim Rasool (L) whilst on the campaign trail before general elections on 8 May 2019

Source: Shutterstock

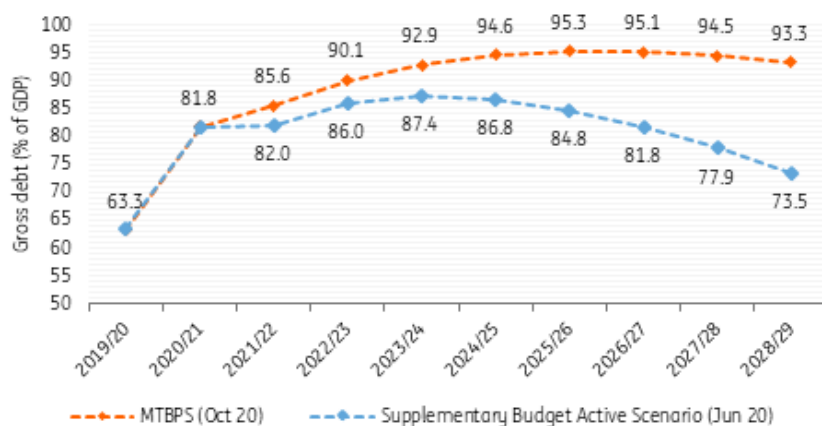
Economic recovery and fiscal consolidation key for debt stabilisation

For the current fiscal year, the MTBPS largely reaffirmed the forecasts made in June, notably a 15.7% of GDP fiscal deficit lifting gross government debt to 82% of GDP by March 2021 (from 63% a year earlier).

In the medium term, the National Treasury expects growth to average 2.1% and the fiscal deficit to gradually narrow to 7.3% of GDP with debt/GDP continuing to rise to 93% by 2023/24. Eventually, a main budget primary surplus and debt stabilisation (at 95% of GDP) would be achieved by 2025/26, two years later and at a higher level than in the active scenario presented in

June (87% in 2023/24). However, it also reflects the National Treasury's confidence that an uncontrolled debt spiral, in line with the June passive scenario with debt/GDP rising to 141% by 2028/29, can be avoided.

Gross debt outlook under October MTBPS vs active scenario in June budget (% of GDP)



Source: National Treasury, ING

Reaching spending cut rests upon public sector wage negotiations

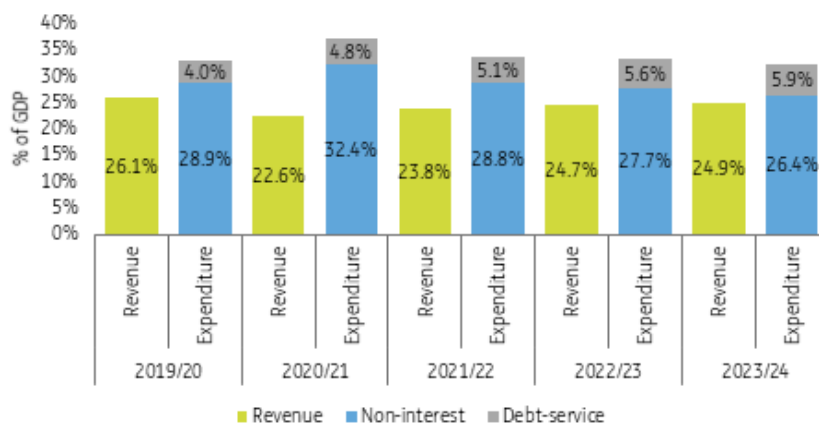
Fiscal consolidation is largely achieved through spending cuts, notably a reduction in non-interest expenditure in the medium-term by ZAR300bn vs the 2020 budget (ZAR60bn in 2021/22, ZAR90bn in 2022/23 and ZAR150bn in 2023/24) as well as the planned introduction of zero-based budgeting (where spending allocations are matched with revenues, rather than previous year's spending) from 2022 onwards.

In line with the February budget, the MTBPS singles out the public sector wage bill as the main area with a proposal to freeze wages for the next three years, thus limiting the growth of employee compensation to an annual average of 0.8%. This will be contingent on wage negotiations with unions which will likely start around the turn of the year.

All in all, this would yield a reduction in the share of main budget non-interest spending by 6ppt over the medium term to 26% of GDP in 2023/24. However, debt service costs are projected to rise steadily (to 6% of GDP or 24% of revenues by 2023/24).

The pandemic has created a substantial and persisting revenue shortfall vs the 2020 budget, estimated to be ZAR313bn in 2020/21, ZAR233bn in 2021/22 and ZAR217.5bn in 2022/23. The MTBPS indicates only minor tax increases between ZAR5-15bn annually from next year onwards. Thus, main budget revenues are expected to recover gradually (from 23% of GDP in 2020/21 to 25% in 2023/24) but remain below previous levels.

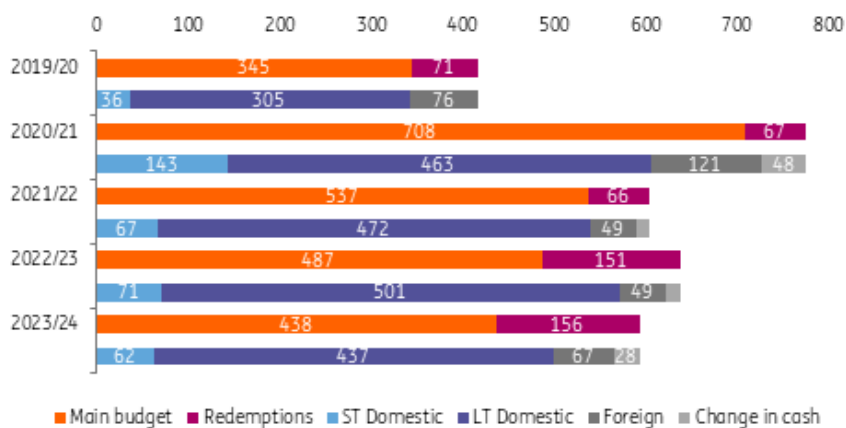
Main budget revenues vs spending (% of GDP)



Source: National Treasury, ING

The record deficit has resulted in substantial funding needs for the current fiscal year (ZAR775bn), which are mainly shouldered by the domestic market. The government is focussed on short-term borrowing (ZAR143bn vs ZAR48bn in 2020 budget), which has somewhat eased the pressure on long-term borrowing (ZAR463bn vs ZAR338bn). Foreign funding (ZAR121bn or US\$7.3bn) has been sourced from IFIs (notably the IMF, New Development Bank and the AfDB) with US\$5.5bn disbursed so far and the remainder expected by March 2021. Talks with the World Bank remain ongoing.

Gross borrowing requirement and financing (ZARbn)



Source: National Treasury, ING

Budget viability stands and falls with wage bill talks, SOE risk persists

The MTBPS has come much in line with market expectations by reaffirming this year's substantial economic and fiscal fallout while promising fiscal consolidation based on accelerating growth and the realisation of revenue/expenditure targets.

However, the government will face a harsh reality test over the next half year, with asymmetric downside risks from the upcoming court decision on this year's wage freeze and 1H21 wage

negotiations. A decision in favour of restoring this year's wage hike would have negative consequences for the current fiscal year (ZAR38bn negative impact) and would embolden unions to demand wage growth to at least cover inflation (averaging 4.3% in the medium term). Against that, the National Treasury has identified no noteworthy alternative to the public sector wage freeze.

Moreover, contingent liability risks from SOEs remain very high and unaddressed, notably regarding Eskom's debt burden and organisational restructuring. Government support of ZAR49bn has filled a debt service gap of ZAR29bn in the financial year ending March 2020. However, this hasn't prevented the utility from revealing a ZAR20.5bn net loss (vs ZAR20.9bn loss in FY19) and warning of a further deterioration in the current financial year ending March 2021 (with operating profit turning negative and a net loss of ZAR26.2bn forecasted).

2021 could shape up as a consequential year but at this point it appears that those challenges will remain unresolved by the time of the February 2021 budget. With a major GDP contraction behind us, there is some hope that the government can build on President Ramaphosa's Economic Reconstruction and Recovery Plan to finally generate some momentum behind economic and structural reforms while tackling state capture.

Rating agencies are doubtful but will wait for a clearer picture in 2021

Continued fiscal deterioration, subdued growth and the Covid-19 shock have resulted in downgrades by all rating agencies in 2020. Moody's and Fitch have retained their negative outlooks due to risks of a further weakening in the fiscal and economic outlook, driven by the pandemic, structural impediments to growth and uncertainty about the prospects of fiscal consolidation.

Following the MTBPS, rating agencies remain pessimistic but will likely wait for more clarity on the wage bill negotiations and signs of economic reform momentum. Notably Moody's will also closely follow the trajectory of financing costs.

- Fitch (BB neg) highlighted the large dependence on wage negotiations, which will run at least until the expiry of the current wage agreement in April 2021. Notably, "the track record on negotiating wage agreements in line with budget assumptions is weak, and there is limited room for offsetting measures in other expenditure areas." Moreover, growth is expected to remain weak and policymaking hampered by tensions within the ANC while risks could come from social pressure for additional spending. The negative outlook on the BB rating reflects the "prospect of further significant pressure on government debt".
- Moody's downgraded South Africa to Ba1 in March (from Baa3). The rating agency said that the MTBPS was weak on specifics and timing of economic reform and debt stabilisation measures, while negotiations on the wage bill will be difficult. Moreover, Moody's also noted that yields on 10-year local currency government bonds have continued to rise. All in all, Moody's expects growth to remain subdued and fiscal consolidation to be insufficient to arrest the rise in government debt. Regarding the latter, fiscal deficits are expected to be around 2.5ppt of GDP wider than the MTBPS in each year from 2021 onwards and with South Africa remaining distant from debt sustainability (with a 4.7% primary deficit in FY2022/23 vs a 2.5% primary surplus needed to stabilise debt/GDP).
- S&P has the lowest rating (BB-) among the three rating agencies, but holds a stable outlook

which “reflects the balance between pressures related to very low GDP growth and high fiscal deficits, against the sovereign’s deep financial markets and monetary flexibility.” We believe that the rating agency will hold off from revising the outlook to negative for now, despite the worsening fiscal trajectory.

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

Agency (review date)	Upgrade Drivers	Downgrade Drivers
Moody's Ba1 negative (20 Nov)	<p>For outlook back to stable: Medium-term fiscal consolidation strategy credibly curbs the upward trend in debt burden, contingent on prospects of a slow but durable pick-up in growth, financing risks remaining low and debt affordable, and a gradual reduction in primary deficits; indicators include:</p> <ul style="list-style-type: none"> • Government's ability to promote the economic recovery and to agree and begin to implement pro-growth structural reforms • Implementation of the framework for a reliable supply of power and fiscal reforms to contain expenditure and enhance revenues 	<p>Greater uncertainty regarding the eventual stabilisation of government debt or indications that the government's access to funding at manageable costs has structurally deteriorated, indicators being:</p> <ul style="list-style-type: none"> • Growth will remain very weak and the primary deficit wide • Financing costs rise significantly
S&P BB- stable (20 Nov)	<ul style="list-style-type: none"> • Credible reform efforts credibly arrest rise in government debt-to-GDP ratio • Substantial improvement in job creation and productivity gains, leading to higher real per capita GDP growth 	<ul style="list-style-type: none"> • Economic prospects fail to recover during forecast period and financing pressures mount • Significant weakening of rule of law, property rights, or enforcement of contracts which undermines the investment and economic outlook
Fitch BB negative (N/A)	<ul style="list-style-type: none"> • Formulation of a clear and credible path towards stabilising the government debt/GDP ratio over the medium term • Strengthening trend GDP growth 	<ul style="list-style-type: none"> • Continued rise in government debt/GDP and failure to formulate a clear and credible path towards stabilising the government debt/GDP ratio • Further deterioration in trend GDP growth rate

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

The MTBPS has come roughly in line with market expectations and envisages debt stabilisation two years later and at a higher level compared to the active scenario presented in June (95% by March 2026 vs 87% in March 2024). However, this remains a highly ambitious target that rests on the government’s ability to follow through with a public sector wage freeze, implying asymmetric downside risks. Markets will closely follow a court ruling (likely in December) on the government’s decision to freeze wages in 2020, which poses downside risks for the current fiscal year and could embolden unions in 1H21 wage talks. Moreover, contingent liability risks from SOEs remain very high and unaddressed, notably with Eskom remaining highly dependent on government support and operational performance set to worsen.

Author

Olivia Grace

Editor

olivia.grace@ing.com

Julian Geib

Junior Economist, Global Trade

julian.geib@ing.de

Zoltán Homolya

Economic research trainee

zoltan.homolya@ing.com

Amrita Naik Nimbalkar

Junior Economist, Global Macro

amrita.naik.nimbalkar@ing.com

Mateusz Sutowicz

Senior Economist, Poland

mateusz.sutowicz@ing.pl

Alissa Lefebre

Economist

alissa.lefebvre@ing.com

Deepali Bhargava

Regional Head of Research, Asia-Pacific

Deepali.Bhargava@ing.com

Ruben Dewitte

Economist

+32495364780

ruben.dewitte@ing.com

Kinga Havasi

Economic research trainee

kinga.havasi@ing.com

Marten van Garderen

Consumer Economist, Netherlands

marten.van.garderen@ing.com

David Havrlant

Chief Economist, Czech Republic

420 770 321 486

david.havrlant@ing.com

Sander Burgers

Senior Economist, Dutch Housing

sander.burgers@ing.com

Lynn Song

Chief Economist, Greater China

lynn.song@ing.com

Michiel Tukker

Senior UK & Eurozone Rates Strategist

michiel.tukker@ing.com

Michal Rubaszek

Senior Economist, Poland

michal.rubaszek@ing.pl

This is a test author

Stefan Posea

Economist, Romania

tiberiu-stefan.posea@ing.com

Marine Leleux

Sector Strategist, Financials

marine.leleux2@ing.com

Jesse Norcross

Senior Sector Strategist, Real Estate

jesse.norcross@ing.com

Teise Stellema

Research Assistant, Energy Transition

teise.stellema@ing.com

Diederik Stadig

Senior Economist, Healthcare & Technology

diederik.stadig@ing.com

Diogo Gouveia

Sector Economist

diogo.duarte.vieira.de.gouveia@ing.com

Marine Leleux

Sector Strategist, Financials

marine.leleux2@ing.com

Ewa Manthey

Commodities Strategist

ewa.manthey@ing.com

ING Analysts

James Wilson

EM Sovereign Strategist

James.wilson@ing.com

Sophie Smith

Digital Editor

sophie.smith@ing.com

Frantisek Taborsky
EMEA FX & FI Strategist
frantisek.taborsky@ing.com

Adam Antoniak
Senior Economist, Poland
adam.antoniak@ing.pl

Min Joo Kang
Senior Economist, South Korea and Japan
min.joo.kang@ing.com

Coco Zhang
ESG Research
coco.zhang@ing.com

Jan Frederik Slijkerman
Senior Sector Strategist, TMT
jan.frederik.slijkerman@ing.com

Katinka Jongkind
Senior Economist, Services and Leisure
Katinka.Jongkind@ing.com

Marina Le Blanc
Sector Strategist, Financials
Marina.Le.Blanc@ing.com

Samuel Abettan
Junior Economist
samuel.abettan@ing.com

Franziska Biehl
Senior Economist, Germany
Franziska.Marie.Biehl@ing.de

Rebecca Byrne
Deputy Global Head of Editorial and Supervisory Analyst
rebecca.byrne@ing.com

Mirjam Bani
Sector Economist, Commercial Real Estate & Public Sector (Netherlands)
mirjam.bani@ing.com

Timothy Rahill
Credit Strategist
timothy.rahill@ing.com

Leszek Kasek

Senior Economist, Poland

leszek.kasek@ing.pl

Antoine Bouvet

Head of European Rates Strategy

antoine.bouvet@ing.com

Jeroen van den Broek

Global Head of Sector Research

jeroen.van.den.broek@ing.com

Edse Dantuma

Senior Sector Economist, Industry and Healthcare

edse.dantuma@ing.com

Francesco Pesole

FX Strategist

francesco.pesole@ing.com

Rico Luman

Senior Sector Economist, Transport and Logistics

Rico.Luman@ing.com

Jurjen Witteveen

Sector Economist

jurjen.witteveen@ing.com

Dmitry Dolgin

Chief Economist, CIS

dmitry.dolgin@ing.de

Nicholas Mapa

Senior Economist, Philippines

nicholas.antonio.mapa@asia.ing.com

Egor Fedorov

Senior Credit Analyst

egor.fedorov@ing.com

Sebastian Franke

Consumer Economist

sebastian.franke@ing.de

Gerben Hieminga

Senior Sector Economist, Energy

gerben.hieminga@ing.com

Nadège Tillier

Head of Corporate Sector Strategy

nadege.tillier@ing.com

Charlotte de Montpellier

Senior Economist, France and Switzerland

charlotte.de.montpellier@ing.com

Laura Straeter

Behavioural Scientist

+31(0)611172684

laura.Straeter@ing.com

Valentin Tataru

Chief Economist, Romania

valentin.tataru@ing.com

James Smith

Developed Markets Economist, UK

james.smith@ing.com

Suvi Platerink Kosonen

Senior Sector Strategist, Financials

suvi.platerink-kosonen@ing.com

Thijs Geijer

Senior Sector Economist, Food & Agri

thijs.geijer@ing.com

Maurice van Sante

Senior Economist Construction & Team Lead Sectors

maurice.van.sante@ing.com

Marcel Klok

Senior Economist, Netherlands

marcel.klok@ing.com

Paolo Pizzoli

Senior Economist, Italy, Greece

paolo.pizzoli@ing.com

Marieke Blom

Chief Economist and Global Head of Research

marieke.blom@ing.com

Raoul Leering

Senior Macro Economist

raoul.leering@ing.com

Maarten Leen

Head of Global IFRS9 ME Scenarios

maarten.leen@ing.com

Maureen Schuller

Head of Financials Sector Strategy

Maureen.Schuller@ing.com

Warren Patterson

Head of Commodities Strategy

Warren.Patterson@ing.com

Rafal Benecki

Chief Economist, Poland

rafal.benecki@ing.pl

Philippe Ledent

Senior Economist, Belgium, Luxembourg

philippe.ledent@ing.com

Peter Virovacz

Senior Economist, Hungary

peter.virovacz@ing.com

Inga Fechner

Senior Economist, Global Trade

inga.fechner@ing.de

Dimitry Fleming

Senior Data Analyst, Netherlands

Dimitry.Fleming@ing.com

Ciprian Dascalu

Chief Economist, Romania

+40 31 406 8990

ciprian.dascalu@ing.com

Muhammet Mercan

Chief Economist, Turkey

muhammet.mercan@ingbank.com.tr

Iris Pang

Chief Economist, Greater China

iris.pang@asia.ing.com

Sophie Freeman

Writer, Group Research

+44 20 7767 6209

Sophie.Freeman@uk.ing.com

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

James Knightley

Chief International Economist, US

james.knightley@ing.com

Tim Condon

Asia Chief Economist

+65 6232-6020

Martin van Vliet

Senior Interest Rate Strategist

+31 20 563 8801

martin.van.vliet@ing.com

Karol Pogorzelski

Senior Economist, Poland

Karol.Pogorzelski@ing.pl

Carsten Brzeski

Global Head of Macro

carsten.brzeski@ing.de

Viraj Patel

Foreign Exchange Strategist

+44 20 7767 6405

viraj.patel@ing.com

Owen Thomas

Global Head of Editorial Content

+44 (0) 207 767 5331

owen.thomas@ing.com

Bert Colijn

Chief Economist, Netherlands

bert.colijn@ing.com

Peter Vanden Houte

Chief Economist, Belgium, Luxembourg, Eurozone

peter.vandenhoute@ing.com

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@ing.com

Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE

chris.turner@ing.com

Gustavo Rangel

Chief Economist, LATAM

+1 646 424 6464

gustavo.rangel@ing.com

Carlo Cocuzzo

Economist, Digital Finance

+44 20 7767 5306

carlo.cocuzzo@ing.com