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

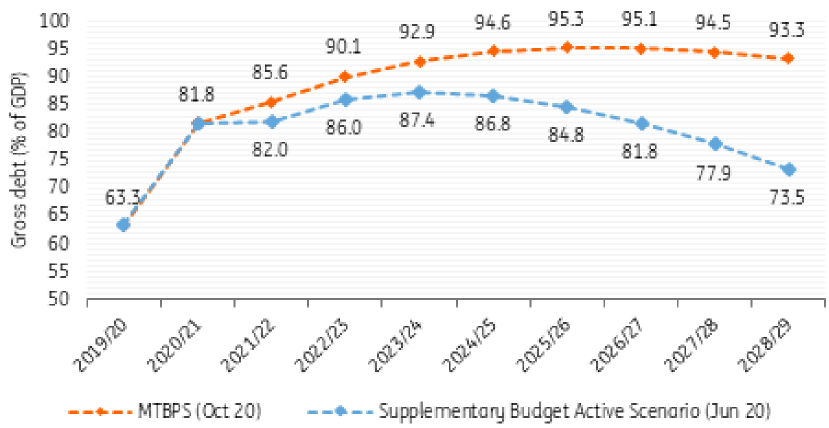
Economic recovery and fiscal consolidation key for debt stabilisation

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

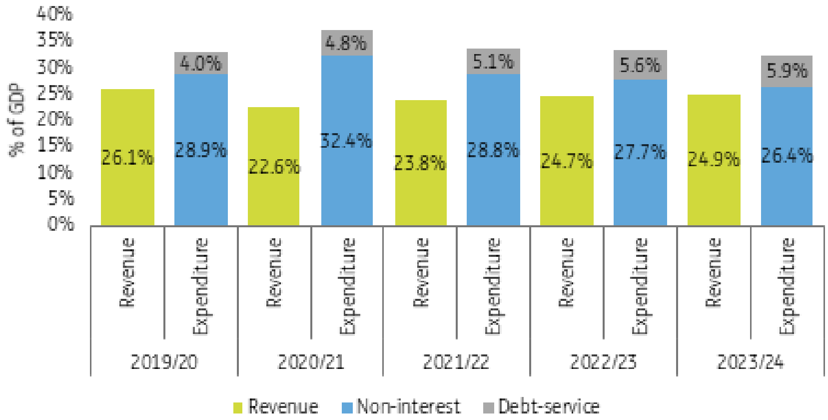
Fiscal consolidation is largely achieved through spending cuts, notably a reduction in non-interest expenditure in the medium-term by ZAR300bn vs the 2020 budget (ZAR60bn in 2021/22, ZAR90bn in 2022/23 and ZAR150bn in 2023/24) as well as the planned introduction of zero-based budgeting (where spending 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.

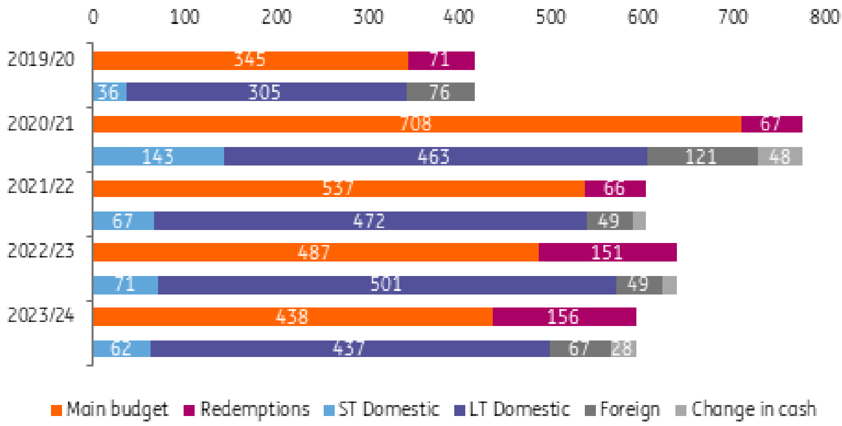
Main budget revenues vs spending (% of GDP)



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 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)	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: • **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	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: • **Growth** will remain very weak and the primary deficit wide • **Financing costs** rise significantly
S&P BB- stable (20 Nov)	• 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**	• **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)	• Formulation of a clear and credible path towards stabilising the **government debt/GDP ratio** over the medium term • 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 • 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.

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