25 February 2020
South Africa

South Africa and the Rand

On the lookout for an (in)credible budget

Contents

- **Budget**: Restoring debt sustainability will prove challenging
- **Eskom**: Some progress and some talk, but setbacks predestined
- **Moody's**: Focus on tax compliance and spending containment
- **Rand**: The budget is just one of many challenges

With debt sustainability thrown into question and a Moody's downgrade on the cards following October's mid-term budget, **tomorrow's budget statement** (2pm local time/12pm GMT) **will be scrutinised for concrete measures to contain the damage**.

It will be challenging for Finance Minister Tito Mboweni to convince investors that debt sustainability can be restored in the medium term, but **measures in line with what was outlined in the mid-term budget should suffice to avert an imminent downgrade by Moody's. Downgrade risk across all three rating agencies (Baa3 neg/BB neg/BB+ neg) remains high throughout 2020** on further growth cuts (and consequently lower tax revenues) and insufficient containment of spending pressure. In the near term, we also expect further headlines on Eskom, notably on the ongoing organisational restructuring and recent discussions to reduce the utility's debt burden.

Having briefly touched 14.00 at the start of 2020 on hopes for a global recovery, **USD/ZAR has since rallied 8% as the spread of the coronavirus has hit expected Chinese commodity demand** and, most recently, global risk assets.

If tomorrow's South African budget can somehow show a debt-to-GDP path stabilising at around 70% of GDP – consistent with investment grade peers – the rand could enjoy some temporary relief. However, any correction to the 14.75/85 area in USD/ZAR should be brief and **our current targets of 15.50 for 1Q20 are probably too low**, because the rand does not look especially cheap.

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Budget: Restoring debt sustainability will prove challenging

The stakes are high as usual as the government tries to stave off a Moody's downgrade (Baa3 neg) despite the very bleak outlook presented in the October 2019 Medium Term Budget Policy Statement (MTBPS). Most notably, the National Treasury warned that gross debt to GDP would increase from 61% in 2019/20 to beyond 80% over the next decade without additional fiscal adjustments.

Mboweni specified that the government was looking for ways to stabilise debt (as a percentage of GDP) by 2025/26 and achieve a primary balance (excluding financial support for Eskom) by 2022/23. This will prove challenging for two main reasons.

First, the likelihood of an economic recovery has been dampened by the coronavirus outbreak globally and ongoing power cuts locally. Recent estimates see growth limited to 0.8% compared to 0.3% in 2019 (Bloomberg consensus). Compared to the MTBPS's 1.2% forecast (see tables below), this implies downside to tax revenues and pressure on fiscal spending (President Cyril Ramaphosa said that the budget would set aside 1% of the budget for youth unemployment).

MTBPS 2019/rating agency macro projections (in %)

		2019	2020	2021	2022
Real GDP growth	**MTBPS (Oct 19)**	**0.5**	**1.2**	**1.6**	**1.7**
	Moody's (Nov 19)	0.7	1.0	1.2	
	S&P (Nov 19)	0.6	1.6	1.9	1.9
	Fitch (Dec 19)	0.4	1.5	1.7	
CPI inflation	**MTBPS (Oct 19)**	**4.3**	**4.9**	**4.8**	**4.8**
	Moody's (Nov 19)	4.5	5.0	5.0	
	S&P (Nov 19)	4.3	4.9	4.7	4.7
	Fitch (Dec 19)	4.2	4.4	5.0	
Current account balance (% of GDP)	**MTBPS (Oct 19)**	**-3.4**	**-3.5**	**-3.5**	**-3.5**
	Moody's (Nov 19)	-3.4	-3.6	-3.7	
	S&P (Nov 19)	-3.9	-3.6	-3.8	-4.1
	Fitch (Dec 19)	-3.9	-3.9	-3.9	

Source: National Treasury, rating agencies, ING

MTBPS 2019/rating agency fiscal projections (in %)

		2019/20	2020/21	2021/22	2022/23
Revenue (% of GDP)	**MTBPS (Oct 19)**	**29.5**	**29.3**	**29.4**	**29.3**
	Moody's (Nov 19)	29.0	29.0	29.1	
	S&P (Nov 19) *	29.8	29.9	29.9	29.9
	Fitch (Dec 19)	29.8	30.2	30.6	
Expenditure (% of GDP)	**MTBPS (Oct 19)**	**35.4**	**35.8**	**35.6**	**35.3**
	Moody's (Nov 19)	35.2	35.6	35.5	
	S&P (Nov 19) *	35.8	36.6	36.3	35.9
	Fitch (Dec 19)	35.8	36.5	36.3	
Budget balance (% of GDP)	**MTBPS (Oct 19)**	**-5.9**	**-6.5**	**-6.2**	**-5.9**
	Moody's (Nov 19)	-6.3	-6.6	-6.4	
	S&P (Nov 19) *	-6.0	-6.6	-6.3	-6.0
	Fitch (Dec 19)	-6.0	-6.2	-5.7	
Gross debt (% of GDP)	**MTBPS (Oct 19)**	**60.8**	**64.9**	**68.5**	**71.3**
	Moody's (Nov 19)	67.1	71.3	75.0	
	S&P (Nov 19) *	62.5	65.9	69.0	71.5
	Fitch (Dec 19)	63.3	67.6	71.3	

Source: National Treasury, rating agencies, ING – * FY figures (not fiscal year)

Second, high inequality and unemployment rates (29%) limit the government's options to restore debt sustainability. The MTBPS pointed to additional adjustment requirements exceeding ZAR150 billion (c.US$10bn) over three years to achieve the primary balance target, primarily coming from (1) the reduction in the public sector wage bill, (2) taxes and (3) measures on state-owned companies:

- **Public sector wage bill**: Employee compensation accounted for 34% of FY19/20 spending. The Congress of South African Trade Unions (Cosatu) said that the government's suggestions included 30,000 job cuts and a three-year pay freeze. However, the current wage agreement only expires in 2021 and the timeline for negotiations is unclear, meaning that it will be difficult for Mboweni to present concrete savings, with the risk of disappointment down the line.

- **Taxes**: The MTBPS warned that the room for further tax hikes is limited given significant increases over the past years. Notwithstanding, expectations are for an increase in a combination of taxes that could include value added tax and/or personal income tax as well as excise taxes and fuel levies.

- **State-owned entities (SOEs)**: The MTBPS highlighted the need for a sustainable plan for SOEs which should include the disposal of non-core assets and/or private sector participation. We expect comments regarding the ailing South African Airways.

  However, any comments on Eskom, given the utility's dire state, will receive more attention. Throughout 2019, the government stepped up its support for Eskom with

ZAR138bn (US$9bn) of injections until 2021/22 and further support would be contingent on improvements in operational and financial performance. We are seeing some positive momentum when it comes to dealing with Eskom, with an expected functional separation of the transmission unit by March and the upcoming report by the chief restructuring office to the government.

Recent headlines have circled around proposals to transfer ZAR254bn (c.US$17bn) of debt to the Public Investment Corporation (PIC), the asset manager of the state-owned pension fund, and state development institutions. This would leave Eskom with ZAR200bn of debt. The debt relief would have a limited impact on overall public debt (as it would merely be considered as a liability transfer from one state entity to another) but could result in sustainably lower borrowing costs if matched by concurrent improvements on the operational front. However, the proposal faces high legal hurdles while in the near-term, power cuts are expected to remain in place over the next two years and there are no signs for financial improvements.

All in all, the National Treasury is set to follow through with its commitment to achieve a primary balance in the medium term and stabilise debt over the next decade. More specific measures on the above and targeted expenditure cuts would provide a relief to the public debt outlook compared to the previous MTBPS projections.

Moody's: Focus on tax compliance and spending containment

The budget is all but certain to be closely followed by rating agencies, with all three agencies having revised the sovereign outlook to negative (Fitch in July; Moody's and S&P in November).

Policymakers and investors have been overly focused on Moody's, as South Africa's last investment grade rating (Baa3) is hanging by a thread. We expect the rating agency to release a comment on the budget later this week but concerns of a downgrade could ramp up towards the 27 March review date. A downgrade would exclude local currency SAGB bonds from the World Government Bond Index (WGBI) with a detrimental knock-on effect on portfolio flows and the government's borrowing costs.

The rating agency revised the outlook to negative on 1 November, highlighting that the MTBPS projections were "not [...] consistent with a Baa3 rating" and a "credible fiscal strategy to contain the rise in debt, including in the 2020 budget and statement, will be crucial to sustain the rating at its current level." Adding to the factors supporting a downgrade (see table below), Moody's recently cut South Africa's growth forecast by 0.3 percentage points to 0.7% in 2020 and 0.9% in 2021.

Comments in January indicate that Moody's will scrutinise measures to contain spending and bolster revenues, with potential coming from an improvement in tax compliance. We believe that additional fiscal adjustments in line with or above what was outlined in the MTBPS (>ZAR150bn) and first steps on Eskom should stave off imminent downgrade pressure. With the negative outlook likely to remain in place, downgrade risks will remain high throughout 2020 due to weak growth and tax revenues as well as insufficient containment of spending pressure (notably public wage bill beyond 2021).

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

Agency (Review Dates)	Upgrade Drivers	Downgrade Drivers
Moody's (Baa3 neg) 27 Mar 20 Nov	For change of outlook to stable: • Successful stabilisation of debt ratios over medium term by reining in expenditures, improving tax compliance and by lifting potential growth: o Progress in delivering additional fiscal adjustments needed according to MTBPS o Addressing issues related to corruption and financially weak SOEs sector (particularly Eskom)	• Conditions for change of outlook to stable are not met, leading to erosion in fiscal and/or economic strength: o Diminishing prospects that growth will be sufficient to preserve current income levels for the majority and halt rise in government debt over the medium term o Diminishing resilience to external financing shocks • Growing clarity that the government will not be able to further develop and implement fiscal and economic strategy to halt and reverse the debt trajectory (focus on 2020 budget)
S&P (BB neg) 22 May 20 Nov	For change of outlook to stable: • Government credibly arrests rise in net government debt/GDP ratio, controls fiscal deficits and improves SOEs • Substantial improvement in economic growth outlook	• Continued fiscal deterioration (e.g. higher spending pressure, rising interest costs, crystallisation of contingent liabilities) • Weakening of economic performance • Mounting external funding pressure • Significant weakening in rule of law, property rights or enforcement of contracts
Fitch (BB+ neg) likely around June/July (no official review dates)	For change of outlook to stable: • Formulation of clear and credible path towards stabilising government debt/GDP ratio over the medium term • Strengthening in trend GDP growth	• Failure to formulate in the near term a clear and credible path towards stabilising debt/GDP ratio • Further deterioration in trend GDP growth rate • Increased vulnerability from current account deficit and external financing needs

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

Rand: The budget is just one of many challenges

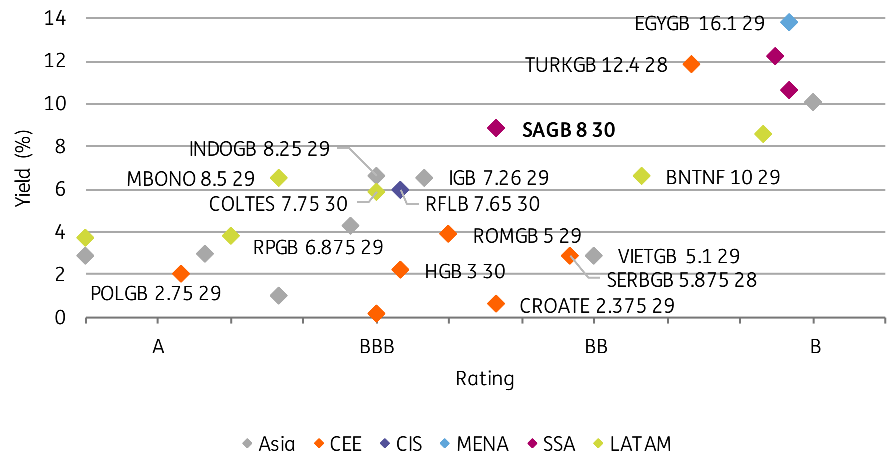
The rand has been demonstrating its high beta status in the emerging world – USD/ZAR dipping to 14.00 at the start of the year as hopes grew for a global recovery (yield curves steepened) only to surge now to 15.20 as the effects of the coronavirus spread beyond Chinese commodity demand to global risk assets.

The issue of South Africa's local currency investment grade status at Moody's has certainly played second fiddle to the geopolitical threats of trade wars and the coronavirus, but could play a role in the short term as the budget event risk hits.

As discussed above, the South African government may do just about enough with tomorrow's budget to appease Moody's. Headlines to focus on here will be whether ZAR150bn+ of budgetary savings can be secured over the next three years and whether the debt to GDP profile can be stabilised – we would say a benchmark is around the 70% of GDP area over the next three to five years, given the very worrying trajectory (80% in 2027/28) presented in October's MTBPS.

Given that SAGBs already trade at a discount to investment grade peers, such a budget could prompt a brief rally in the ZAR – perhaps taking USD/ZAR to the 14.75/85 area.

Persistent risk of losing Moody's Baa3 rating poses a negative technical overhang for South African local currency bonds

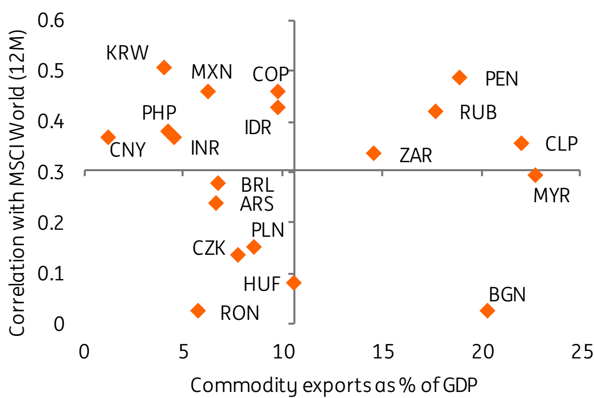


Source: Bloomberg, ING

However, the rand is very much in the cross-hairs of the coronavirus and its impact on commodity demand and risk assets. As highlighted below, the rand sits in the wrong quadrant under this metric, along with the likes of the rouble, Chilean peso and Malaysian ringgit – all hit heavily over recent weeks. Equally, USD/ZAR does not look particularly over-valued on our BEER medium term fair value model, meaning that if things go wrong, USD/ZAR could easily be a 16.50/75 story.

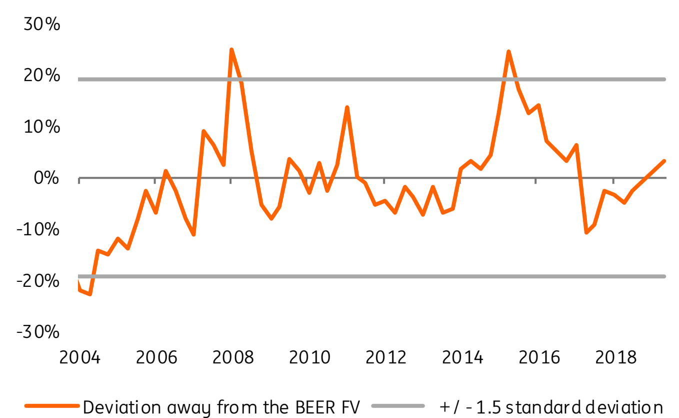
Currently, we are happy with our 1Q20 and 2Q20 targets for USD/ZAR at 15.50. But if the South African government fails to deliver a tight enough budget (triggering a Moody's downgrade and enforced sales of SAGBs) or global equity markets take another big leg lower on virus concerns, 16+ levels in USD/ZAR beckon.

Fig 1 ZAR is exposed to commodities and equities



Source: Bloomberg, ING

Fig 2 USD/ZAR is not particularly overvalued



Source: ING