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IN THIS ISSUE

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A SOBER GLANCE AT GOVERNMENT'S FISCAL FRAMEWORK…

By Mike Schüssler—Brenthurst Wealth Consulting Economist & Elize Kruger

A new Finance Minister, Enoch Godongwana, yet a very similar underlying fiscal scenario. Yes, the headline numbers presented in the Medium-Term Budget Policy Statement (MTBPS) improved notably since the previous Finance Minister, Tito Mboweni, delivered the 2021 National Budget in February, but below the surface the underlying issues have remained.

What does this mean for local investors?

FIRSTLY, WHAT HAS CHANGED SINCE FEBRUARY 2021? TWO THINGS…

South Africa has benefited handsomely from the "post-Covid" surge in global demand for commodities, especially in the first half of 2021. Higher commodity prices have temporarily increased economic growth and boosted tax revenue, especially from mining companies. However, despite the forecast of R120.3bn more to be collected in FY22, tax revenue collections remain well below pre-pandemic expectations, and in this sense the updated numbers flatter to deceive. Compared with Government's 2020 budget projections (pre-Covid), revenue is still expected to be R284.7bn lower than forecast in the three years up until 2022/23.

Over a 12-month rolling average the extra Rand income peaked at just under R28bn extra for export earnings a month. However, the first signs of a commodity price slowdown have arrived and, while prices will remain high, the growth rate in the price of SA exports will slow. Moreover, with both the coal and the iron ore lines suffering massive cable theft, SA has seen a drop in exports that equals approximately R30bn over the last three to four months since the July riots.

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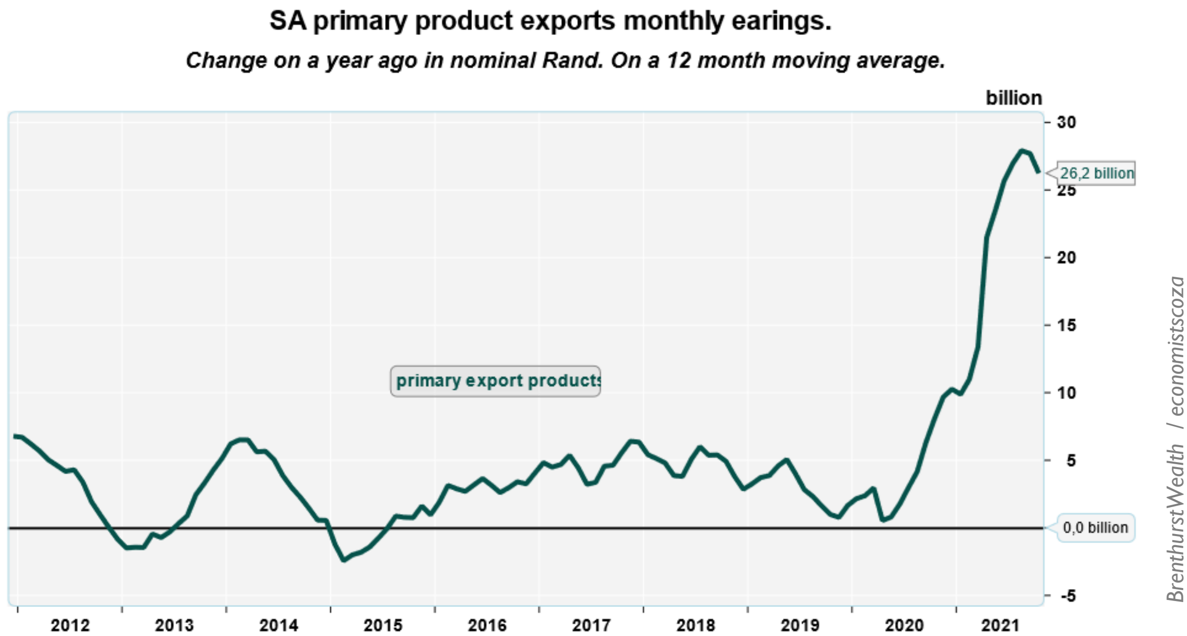
Graph 1: A lucky break, the extra export earnings in billions of rand that SA earned from higher commodity prices.



Then there was the publication of revised estimates of the growth in and size of the South African economy. StatsSA, in collaboration with the South African Reserve Bank, finalised a comprehensive benchmarking and rebasing of South Africa's national accounts.

The benchmarking process is a standard practice embarked upon typically every 5 years and incorporates new information and new methods of measuring the economy. **The revised GDP at current prices indicated that the economy was 11.0% larger in 2020 than previously estimated.**

In the 10 years from 2011 until 2020, the percentage difference between the previous and revised levels averaged around 9.6%, ranging between 8.6% in 2014 and 11.0% in 2020. This notable upward adjustment to the size of the South African economy has resulted in many of the important economic ratios looking better than previously thought, for example Budget Deficit/GDP and Debt/GDP ratios. With the ratios looking somewhat less stretched, it has proven to provide some relief from the pressure of potential further credit rating downgrades. The rating agencies, S&P Global Ratings and Moody’s Investors Service decided not to release any rating updates on scheduled dates in November, keeping their respective views on SA unchanged.

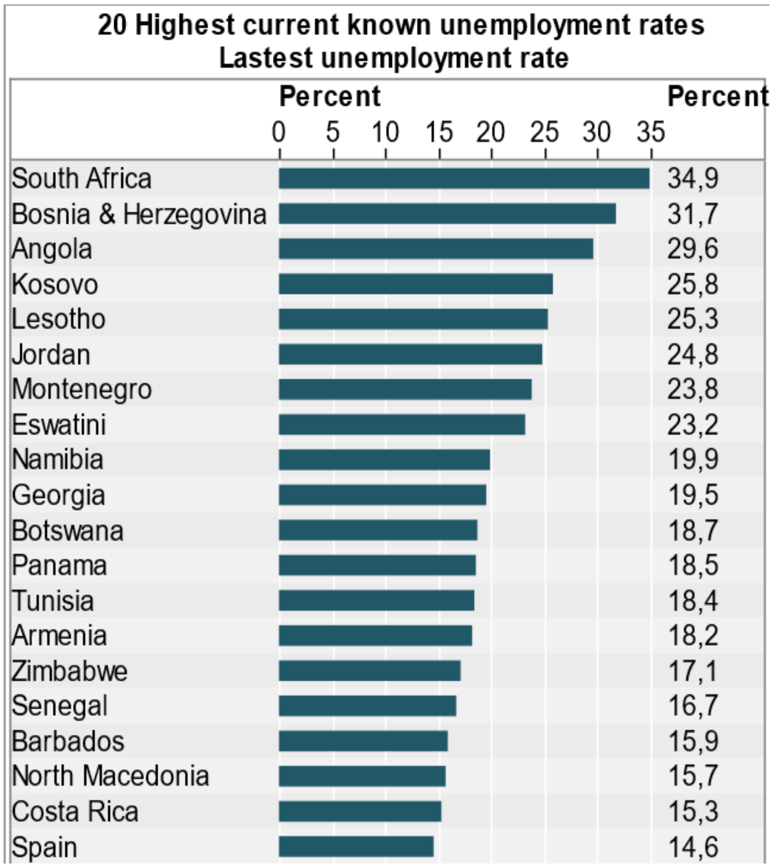
While the GDP benchmarking exercise was indeed credible and necessary, it has resulted in some “window dressing”, while the revenue bonus could add to the feeling that things are looking brighter and better. However, scratching below the surface revealed that a notable number of issues have not changed at all and will continue to strain fiscal sustainability and the health of the South African economy.

CONSIDER THE FOLLOWING:

➲ **THE ECONOMIC RECOVERY HAS BEEN LACKLUSTRE WITH OUTPUT FORECAST NOT TO BE BACK TO PRE-COVID LEVELS UNTIL WELL INTO 2022.** While the first half of 2021 saw a notable recovery off a low base, the unrest and riots in July knocked momentum and the economy contracted by 1.5% q/q in Q3. Renewed periods of loadshedding and the onset of a new Covid-19 variant, with a negative impact on the tourism sector and confidence levels among others, are likely to keep a lid on Q4’s performance as well. Currently, National Treasury is forecasting real economic growth of 5.1% and 1.7% for 2021 and 2022 respectively, similar to the SARB’s views.

In our view, there is downside risk to these forecasts, while growth levels are still too low to make a meaningful dent in the high unemployment problem in South Africa which reached 34.9% in the 3rd quarter, the highest rate by some margin in the world. It seems that after the riots some investors see unemployment as a large political and socio-economic risk factor.

Graph 2: SA leads the world in the highest recent unemployment rates



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➲ STATE-OWNED ENTERPRISES (SOEs) CONTINUE TO PERFORM POORLY AND REQUIRE MORE GOVERNMENT SUPPORT.

Although no specific amounts were allocated to SOE support in the MTBPS, the problem has not gone away and there are still a number of institutions that can simply not operate without the state's capital injections.

Although the new Finance Minister has followed in his predecessor's footsteps with tough talk on the ever-so-needy SOEs, the question remains whether he will walk the tough talk. The jury is out, but in our view more funds will, in all likelihood, be allocated to some SOE's in the 2022 budget, funds that are not currently reflected in the MTBPS expenditure projections

SOE's are already in the red and money will have to be found to meet legal commitments, for example the case of Denel where the company lost the labour court case and must now find at least R2bn to pay employees. The case of SAA seems strange too, where money has to be found as the company still has to pay for some new commitments. Along with some government agencies, such PRASA and SANRAL, government will have to find billions of rands to meet commitments.

➲ ONGOING SPENDING PRESSURE DUE TO THE IMPACT OF THE COVID-19 PANDEMIC REMAINS.

Government responded to the pandemic with emergency fiscal support worth R37.9bn to households and businesses. This included the special COVID-19 social relief of distress grant (SRD) to the amount of R26.7bn, including extending the special COVID-19 SRD grant until end March 2022, whose 9.5 million beneficiaries bring the number of social grant recipients to 27.8 million. In the 2019/20 tax year, SARS noted there were 22.2 million registered taxpayers, of which 6.3 million were expected to submit tax returns. Furthermore, it is estimated that just 25% of those who pay income tax contributed approximately 80% of all personal income tax that is collected, suggesting that around 1.6 million people are shouldering the bulk of all income tax paid, which is clearly an unsustainable situation.

➲ While the previous Finance Minister talked tough on the restraint that is needed for the state wage bill, the recent public service wage agreement resulted in a breach of the budget ceiling for compensation of employees for FY22. **The 2021 wage agreement provides for a pensionable increase of 1.5%, as provided for in the 2021 budget.** However, it includes a once-off non-pensionable cash gratuity of R1 000 after tax per person per month, which was not budgeted for and cost government an additional R20.5bn in the current year, with a preliminary carry through of R20.5bn budgeted for 2022/23, if no new agreement is reached. Clearly government is unable to walk the tough talk…

➲ PUBLIC DEBT HAS INCREASED SEVEN-FOLD, FROM R577BN IN 2007/08 TO OVER R4TN IN 2021/22.

Thus, although the debt-to-GDP ratio is looking better than in February (gross debt is now expected to stabilise in 2025/26 at 78.1% of GDP vs 80.5% of GDP previously), the sheer size of South Africa's mountain of debt is unacceptable and at unsustainable levels. A larger debt stock simply means that interest payments absorb a growing share of national resources, averaging nearly 5% of GDP over the next two years or, put differently, public debt-service costs will, on average, consume 21 cents of every rand collected in main budget revenue over the MTEF period. This crowds out spending on essential public services such as health, social development, peace and security. As long as the interest rate that government pays on its debt is higher than the nominal GDP growth rate of the country, government's debt exposure remains unsustainable.

➲ CONFIDENCE LEVELS IN THE ECONOMY, AMONGST BUSINESSES AND HOUSEHOLDS, REMAINS LOW.

Capital investment, which remains closely correlated with business confidence levels, has been adversely affected by the national lockdowns, policy uncertainty and lack of reliable energy supply, contributing to underspending. Joint initiatives by the National Treasury, the Infrastructure Fund and Infrastructure South Africa aim to improve the scale, speed, quality and efficiency of infrastructure spending, but evidence remains scant.

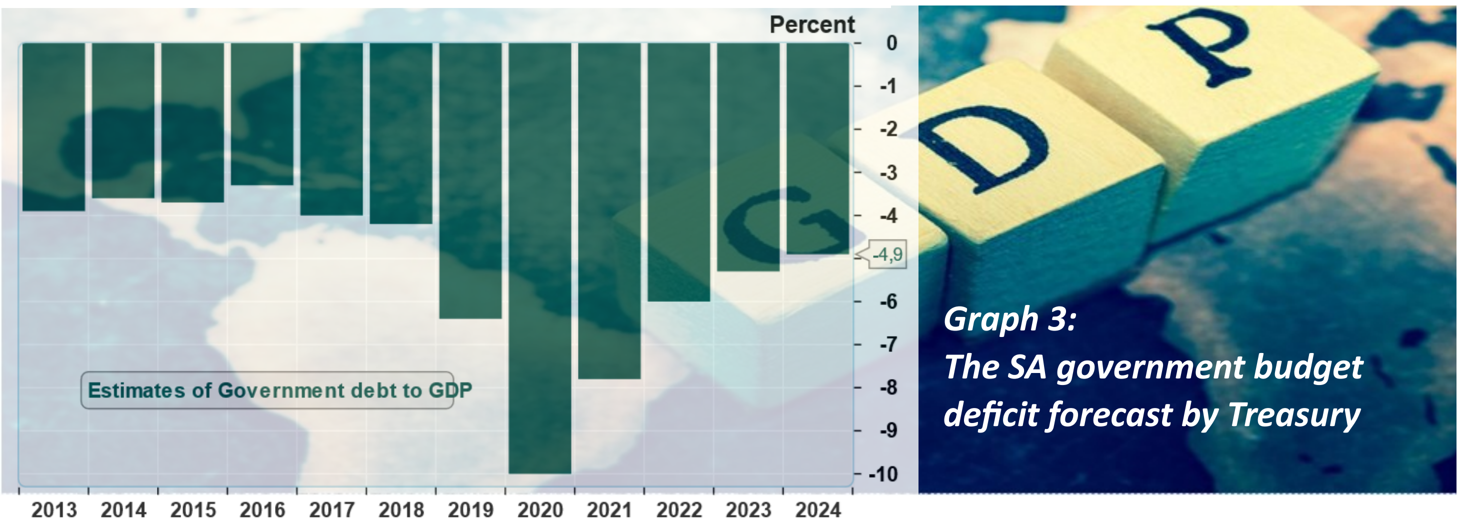
➲ SLOW PROGRESS ON STRUCTURAL REFORM CONTINUES TO KEEP A CEILING ON THE COUNTRY'S POTENTIAL GROWTH RATE.

Although government lists reforms to be accelerated (e.g. diversifying energy generation, releasing broadband spectrum, opening third-party access to the freight rail network, starting the eVisa system rollout, reviewing the legal regime governing skilled migration and accelerating infrastructure investment), most of these were already announced at President Ramaphosa's first State of the Nation address back in 2018. Some progress has been made, but many of the initiatives just aren't implemented and the goalposts just keep being moved.

South Africa's public finances have been in an unsustainable position for years, with government continuously spending more than the economy can afford, and consequently borrowing at an increasing rate to fund the shortfall. The outbreak of the COVID-19 pandemic just made the scenario even worse, resulting in a consolidated budget deficit to GDP ratio of 10% in FY21, the worst ratio since 1940's shortfall of 10.4% of GDP. The combination of better tax receipts and the larger size of the economy subsequently resulted in a moderation in the deficit-to-GDP ratio to 7.8% for FY22. However, considering the bigger picture, issues revealed that the tax windfall and technical adjustment to ratios will only give short-term reprieve.

South Africa is by no means out of the woods yet. Until the more structural issues/problems are addressed with the necessary political will, South Africa's potential GDP is likely to remain constrained and the fiscal scenario quite unsustainable.

Government Budget deficits as Percentage of GDP



Graph 3: The SA government budget deficit forecast by Treasury

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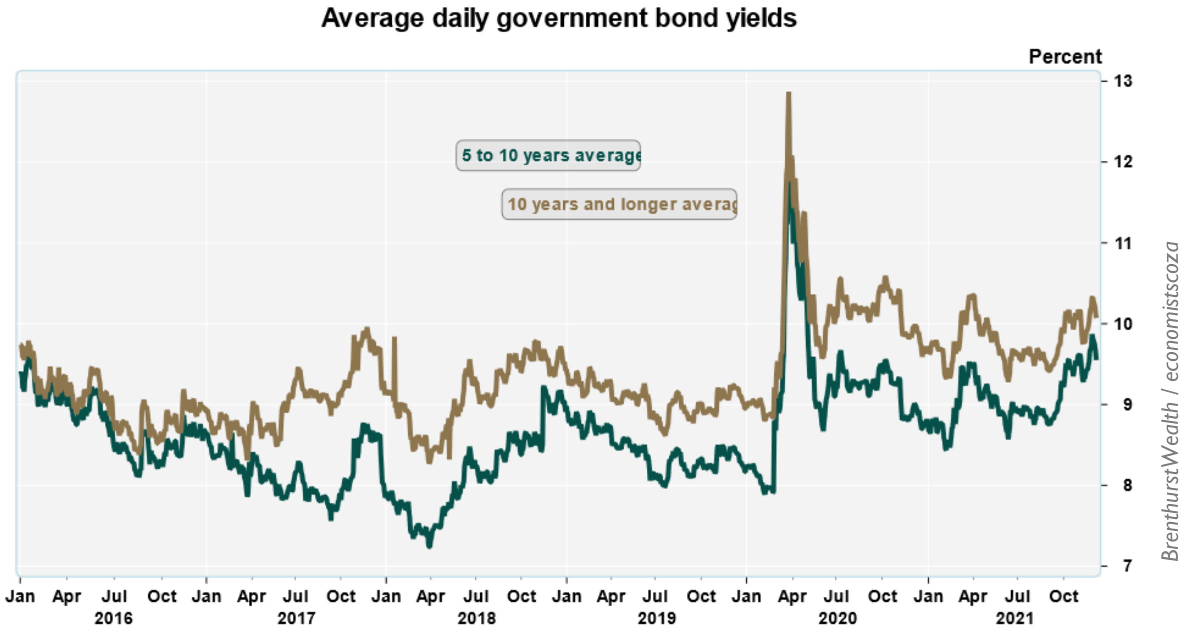
POTENTIAL IMPLICATIONS FOR LOCAL INVESTORS

Assuming the lacklustre local economic performance continues, the likely base case, companies reflecting SA Inc will continue to remain under pressure and could potentially underperform compared to its peers. On the other hand, the question marks that hover over the credibility of the fiscal framework presented and the risk for deviation by the time of the February 2022 budget, will likely keep local bond yields elevated and yield seeking investors interested.

In fact, bond yields are now higher than before the MTBPS and the few days after the 11th of November when the MTBPS took place. Markets have looked at the message and at first were pleased, but feel that something is hidden in the fine print which they do not like.

Graph 4: Government bond yields are up a month after the MTBPS



THE RISK PREMIUM OF SOUTH AFRICA

The Budget Policy Statement has implied promises, and not all of these are likely to be kept. There is a little leeway, but the bigger picture will likely show at least some slippage.

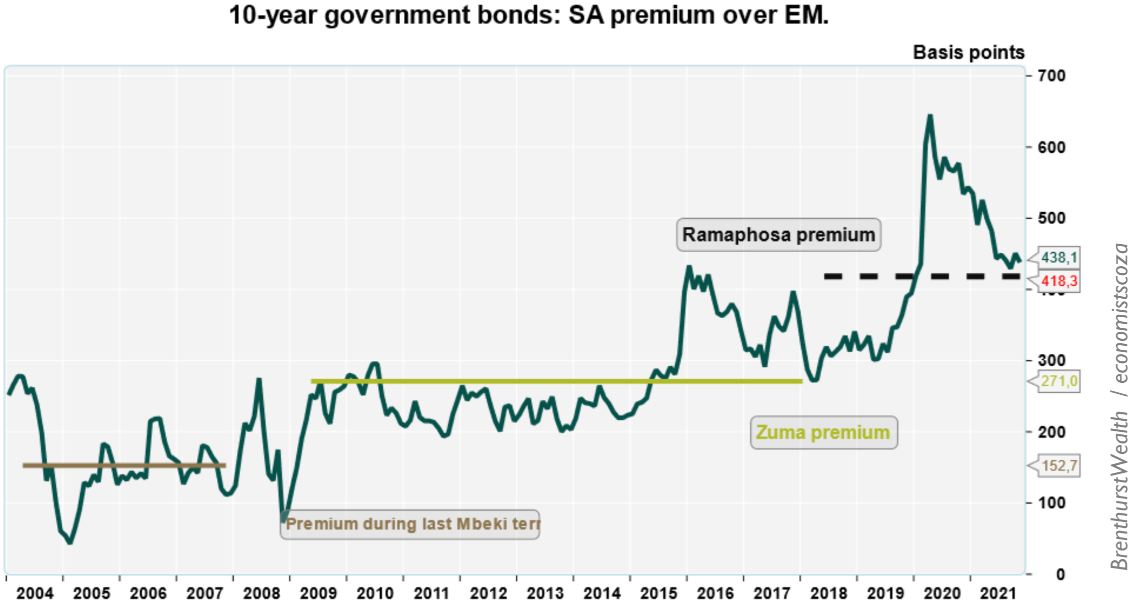
The last point is that South Africa pays a huge risk premium in comparison to other emerging markets. With the thorny issue of Expropriation without Compensation off the table, for now, one can hope for a little consolidation, but the other end is that the MTBPS showed that government is still spending too much.

If government does the right thing this may present a great opportunity, but if the government continues to slip in its commitment, the opportunity will turn out to be a big threat.

A further irony is that, while the local public have been sold the story that President Ramaphosa is the right man to bring South Africa's economy back on a growth track with an honest government that may be a little more careful in merely spending, the market does not believe it. President Ramaphosa's term as president has been characterised by more than twice the risk premium of ex-president Mbeki. Even more worrying is that there is, on average, a 55% risk premium above ex-president Zuma's period risk profile, as ex-president Zuma was widely believed to have been corrupt and ineffective as president of the country, which is quite a shock to most observers. However, one could argue that the damage that was done to South Africa's economy, the tax base, the SOE's and consequently the overall debt burden during the Zuma years of state capture and looting of government coffers are now the reality that president Ramaphosa must handle, and that is clearly what is reflected in the higher bond yields. Investors demand a higher risk premium given the deterioration in fiscal matters, while recognizing that South Africa is under greater pressure to pay back its loans.

One positive at the time of writing is that the parliamentary defeat of EWC has reduced the yield on government bonds and could be a catalyst to SA lowering its risk premium over the medium term. It will, however, be a long and hard road.

Graph 5: The risk premium above other emerging markets is high but may be easing slightly



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