



THE POWER
OF INDEPENDENT ADVICE

IN THIS ISSUE

“ Finance Minister Tito Mboweni warned that South Africa's government debt could hit more than 70% soon.”

MEDIUM-TERM BUDGET IN A NUTSHELL

Finance Minister Tito Mboweni's second Medium-Term Budget Policy Statement (MTBPS) paints a stark financial picture. The consolidated deficit numbers for next year, the 2020/21 fiscal year, have risen from a projection of 4.3% in the February 2019 Budget to 6.5% now. This massive increase reflects the inability of government to make hard decisions. While Mboweni's speech was filled with rhetoric around commitments to cut expenditure and narrow the deficit by February 2020, there were no details on how government proposes to cut spending.

South Africa has one of the steepest yield curves in the world. In English this means that there is a large difference in the interest rate that the government is charged when it borrows for three months (Treasury bills) and when it borrows for longer periods like ten or twenty years. With three-month rates at 6.5% and ten-year yields at 9%, this leaves the differential at 2.5%. Keep in mind that US ten-year bond yields are just over 1.8%, and you begin to understand how large a premium South Africa is paying for longer-term debt.

Short-term interest rates are tethered to the South African Reserve Bank's repo rate. The repo rate in turn is driven by domestic inflation forecasts, which are largely under control. In contrast, longer-term borrowing costs reflect the market's assessment of South Africa's long-term credit worthiness. The numbers in today's MTBPS justify this premium.

Three quarters of the deterioration in the budget deficit can be attributed to weaker growth and therefore disappointing revenues. One quarter of the issue is increased spending, principally on Eskom.

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The solution would have involved a dramatic cut in expenditure – particularly in the wage bills of underperforming and non-critical government departments. Without dealing with the wage bill, very little can be done about government expenditure. Since 2006, the government wage bill has grown from R154bn to R518bn. The increase in personnel accounts for R46bn. Inflation adjustment adds another R158bn. Real wage increases are responsible for another R159bn. With no improvement in public sector service delivery in that period, that makes no sense.

Going forward, government needs to find R250bn in expenditure cuts over the next three years. Bear in mind that a one percentage point increase in the VAT rate raises R25bn in extra revenues. If the government does not cut expenditure, South Africa's debt will not stabilise. The MTBPS projects interest payments to rise from 12% of spending to almost 15% in 2022/23.

The approach the Finance Minister and National Treasury have taken is best summed up by quoting from the budget speech: **“There is no point in publishing a Policy Statement if it simply means publishing the Budget three months early. The purpose is to open up the debate before the (actual) Budget is finalized.”**

Unfortunately, it seems unlikely that the financial markets will give the government the time to make these decisions. South Africa has been given the benefit of the doubt too many times in the past – and has yet to make any of those hard decisions. Is President Ramaphosa ready to take on unions and cut government employees? Can we realistically expect below-inflation wage increases from 2021/2022?

WILL SA RETAIN MOODY'S STABLE OUTLOOK?

MOODY'S REACTION TO THE MTBPS WILL BE KEY. Our base case is that the ratings agency moves SA to a negative outlook on Friday, which it would aim to resolve in 18 months' time. An even worse than expected outcome would be if Moody's moves SA to a negative watch (rather than a negative outlook), which it would aim to resolve in three months' time. Should Moody's somehow decide to leave SA's rating outlook unchanged, it might convince the markets also to give SA the benefit of the doubt – again!

Source: INVESTEC Nazmeera Moola Head of SA Investments, Sisamkele Kobus Fixed Income Analyst

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