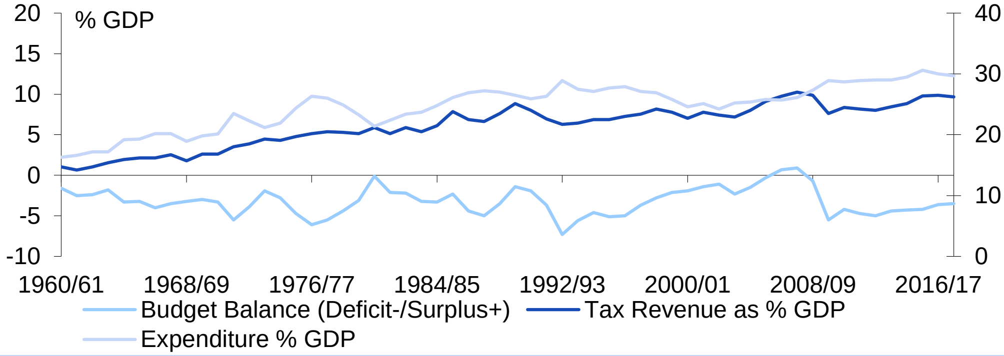
Investec

MTBPS Preview: Commitment to medium term fiscal consolidation expected to be maintained against risk of credit rating downgrades

20th October 2017

Expenditure continues to meaningfully outpace revenue



Sources: SARB

- The 2017 Budget identified the main risks to the fiscal position over the medium term to be "the macroeconomic outlook, budget execution, policy uncertainty and financially distressed state-owned companies." Since the Budget was tabled in February 2017, almost all of these risks remain. Namely, the economy is underperforming, partly as a function of heightened perceived policy and political uncertainty, and several state-owned companies are financially distressed.

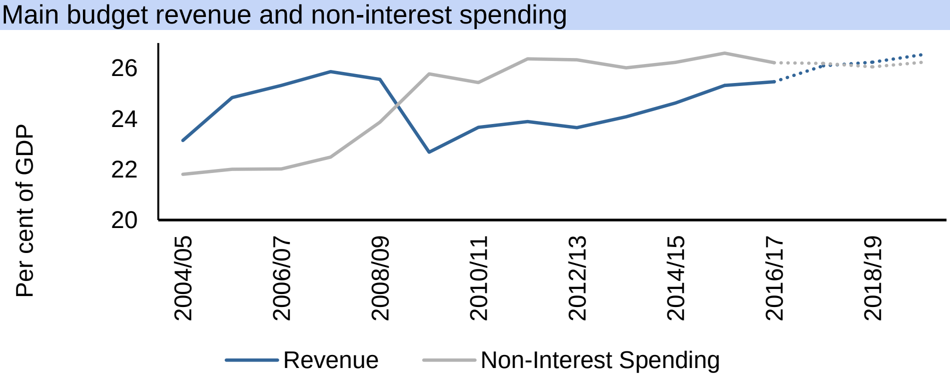
- The Medium Term Budget Policy Statement (MTBPS) to be presented on 25th October 2017 is expected to lower economic growth forecasts, relative to those contained in the 2017 Budget. Lower growth will be a key contributor to the expected deterioration in fiscal indicators.

- The weaker than expected GDP growth outcome is likely to see the consolidated budget deficit figure for 2017/18 come in higher, in the region of -3.5% of GDP, instead of the -3.1% of GDP deficit forecast in the 2017 Budget.

- Achieving a stabilisation of debt ratios will partly rely on addressing the sizeable fiscal risks associated with the realisation of contingent liabilities and/or recapitalisation of state-owned enterprises (SOEs).

- In view of the heightened risk of further sovereign credit rating downgrades, the medium term outlook presented in the MTBPS is expected to demonstrate some degree of fiscal consolidation and a stabilisation of debt ratios. As a point of reference, National Treasury has expressed a commitment to fiscal consolidation plans on a number of occasions over the past few months.

Main budget revenue and non-interest spending



Source: National Treasury, 2017 Budget

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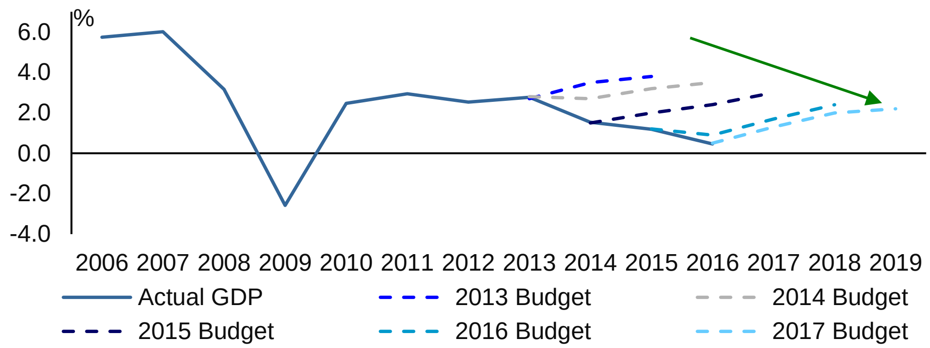
Figure 3: National Treasury real GDP growth forecasts



Source: National Treasury, Stats SA

The 2017 Budget identified the main risks to the fiscal position over the medium term to be "the macroeconomic outlook, budget execution, policy uncertainty and financially distressed state-owned companies." Since the Budget was tabled in February 2017, almost all of these risks remain. Namely, the economy is underperforming, partly as a function of heightened perceived policy and political uncertainty, and several state-owned companies are financially distressed.

The Medium Term Budget Policy Statement (MTBPS), to be presented on 25th October 2017, is therefore expected to lower economic growth forecasts, relative to those contained in the 2017 Budget. Lower growth will be a key contributor to the expected deterioration in fiscal indicators. Specifically, the Budget forecast a moderate improvement in economic growth over the medium term, from 0.5% in 2016 to 1.3% in 2017; 2.0% in 2018 and 2.2% in 2019. With the economy having entered a technical recession in Q1.17 and more recent high frequency indicators suggesting modest levels activity, we expect the economy to achieve growth in the vicinity of 0.5% this year, rising to 2.0% y/y only by 2022. National Treasury is therefore expected to align its forecasts closer to those of the SARB and of the major international authorities (see figure 4).

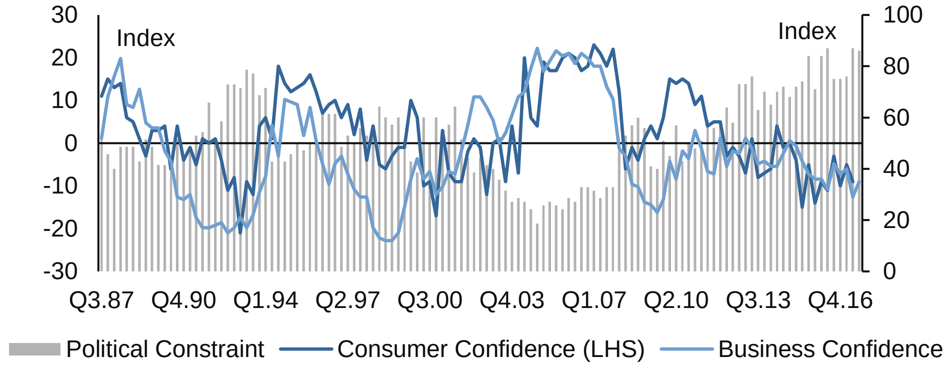
Economic growth (expenditure approach) decelerated from 2.9% y/y in 2011 to 0.5% y/y in 2016 on various structural and cyclical constraints that included unstable electricity supply, fractious labour relations, drought conditions and low commodity prices. These constraints have lifted with the drought easing in most of the country, electricity supply stabilising and the incidence of prolonged strike action decreasing. Additionally, the external economic backdrop is more favourable amid a synchronised uptick in global growth and trade and a lift in international commodity prices. SA's economic growth is being held back by domestic challenges, mainly relating to heightened policy uncertainty that has contributed to the confidence recession (see figure 5). Prolonged policy uncertainty raises the risk of entrenching confidence levels, and therefore economic growth, at low levels.

Figure 4: Real GDP growth, annual forecasts % change

(Date of forecast)	National Treasury *(February 2017)*	SARB *(September 2017)*	IMF *(October 2017)*	World Bank *(October 2017)*
2017	1.3	0.6	0.7	0.6
2018	2.0	1.2	1.1	1.1
2019	2.2	1.5	1.6	1.7

Source: National Treasury, SARB, IMF, World Bank

Figure 5: Confidence and policy uncertainty



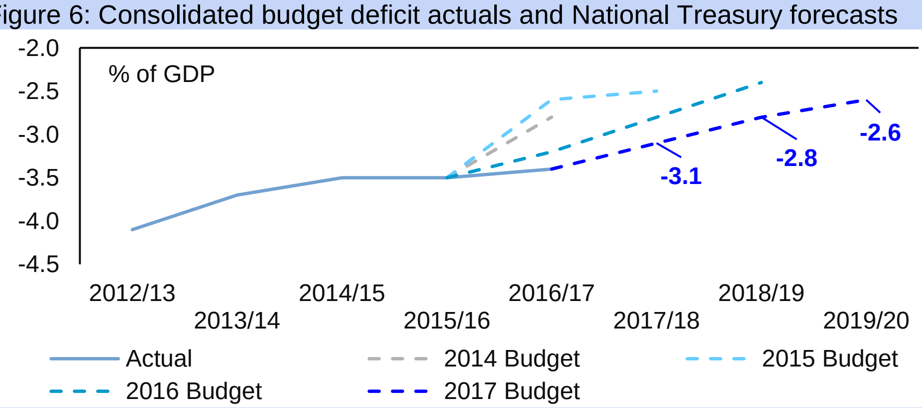
Source: BER

For the 2017/18 fiscal year, we project nominal GDP growth at 6.1% y/y whereas the Budget estimated nominal growth at 7.5% y/y. Lower growth renders it more challenging to adhere to the fiscal consolidation path set out in the 2017 Budget (see figure 6). Specifically, the consolidated budget deficit was projected to decline from 3.4% of GDP in 2016/17, to 3.1% in 2017/18, 2.8% in 2018/19 and to 2.6% by 2019/20. Government's gross loan debt as a percentage of GDP was envisaged to stabilise at 53% in 2018/19 and recede thereafter (see figure 7). However, the weaker than expected GDP growth outcome is likely to see the consolidated budget deficit figure for 2017/18 come in higher, in the region of -3.5% of GDP, instead of the -3.1% of GDP deficit forecast in the 2017 Budget.

The main contributing factor to the forecast wider deficit is a substantial revenue shortfall, of an estimated R38bn. The magnitude of the shortfall is derived from the budget data available to date, which shows that in the first five months of the current 2017/18 fiscal year, tax revenue rose by 6.2% y/y versus estimated growth for the full year of 10.6% y/y. In the event, this would exceed the shortfall of R30bn in 2016/17 and would be the largest shortfall relative to estimates since 2009/10.

Expenditures rose 7.0% y/y in the first five months of the fiscal year, below estimated growth of 7.8% y/y for the full fiscal year. Projections based on this year to date expenditure growth suggest underspending in the region of R10bn in the full fiscal year.

Figure 6: Consolidated budget deficit actuals and National Treasury forecasts



Source: National Treasury

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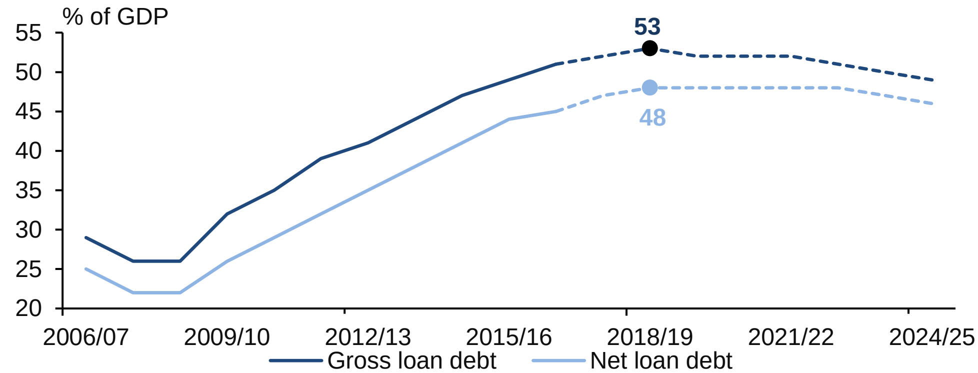
Figure 7: Gross and net debt outlook actuals and National Treasury forecasts

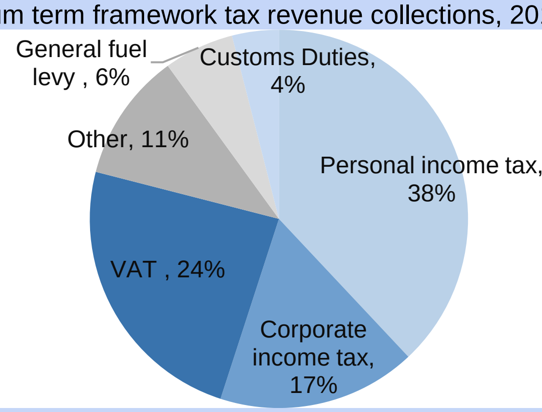


Source: National Treasury, 2017 Budget

These revenue and expenditure side estimates would yield a *main* budget deficit of R193bn compared to the original Budget forecast of R166.8bn which translates to a deficit of 4.1% of GDP versus the -3.5% Budget estimate. The consolidated budget comprises the main budget deficit which is typically partially offset by a combined cash surplus from provinces, social security funds and public entities financed from their own revenue. Moreover, National Treasury could make use of the R6bn contingency reserve to reduce the deficit, as has been the case in the past. Factoring in these considerations yields a *consolidated* budget deficit estimate of -3.5% of GDP.

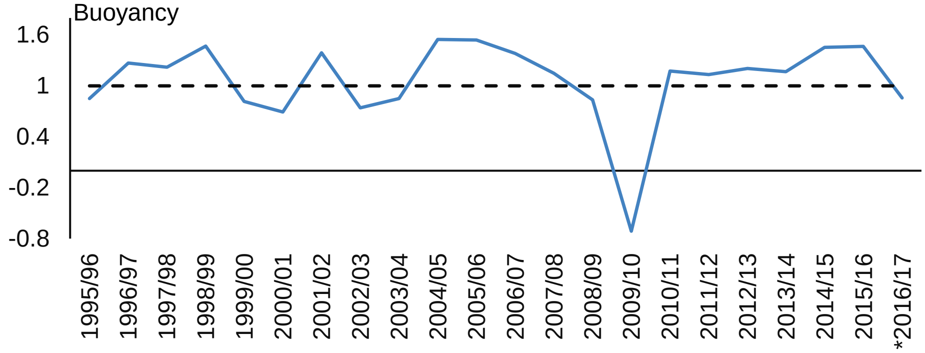
In elaboration of the expected revenue under-collection, in the fiscal year so far, collections have fallen across the major tax categories. In particular, growth in personal and consumption taxes is falling short of targets. Personal income tax collections will have been affected by the technical recession, higher unemployment and slower growth in employee compensation. These factors, along with depressed consumer confidence and weak rates of credit extension have also restrained household consumption expenditure which is the tax base for VAT receipts. Additionally, SARS has expressed concern regarding tax morality and administration and has noted an increase in the level of non-compliance with tax return submissions. This may also be a contributing factor to the lower collections. Consequently, tax buoyancy will likely remain below the long term average of 1.07 and could very well remain below 1.0 as was the case in 2016/17 (see figure 9). A ratio below 1.0 signifies that tax revenues are not growing as fast as the economy.

Figure 8: Medium term framework tax revenue collections, 2017/18 – 2019/20



Source: National Treasury

Figure 9: Gross tax buoyancy



*estimated outcome Source: National Treasury

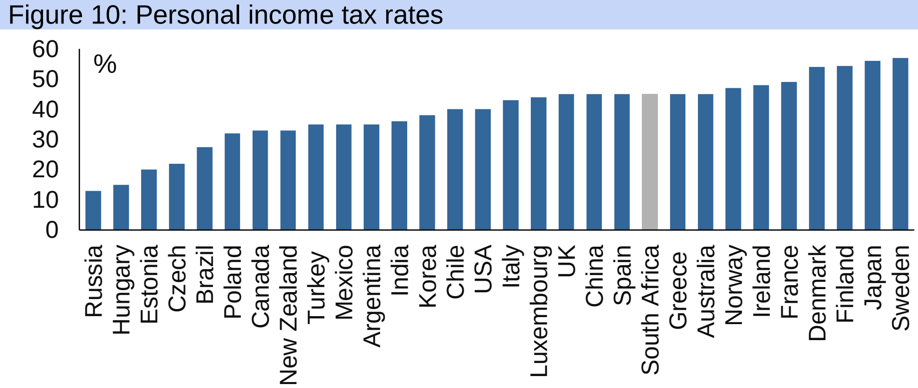
In terms of the Special Voluntary Disclosure Programme, SARS recently reported that 17% of the applications have been processed so far, yielding just over R1.0bn. In total, the Programme should yield in the region of R5bn. Given the magnitude of the projected tax revenue shortfall, these collections are not envisaged to make a meaningful difference.

The muted economic growth prospects suggest that tax revenue collections are likely to remain under some pressure over the medium term framework period. As such, the MTBPS is likely to indicate that additional revenue side policy measures will be implemented. Such measures would be detailed in the 2018 Budget and could include restricted fiscal drag, some form of a wealth tax and removing the zero-rating on fuel to expand the VAT base. The latter would be combined with either a freeze or a decrease in the fuel levy to mitigate the effect on transport costs.

The 2017 Budget noted that given the limited scope to continue raising the personal income tax burden "(i)f growth does not accelerate over the medium term, it may be necessary to adjust consumption taxes. The least economically damaging means of doing so would be to increase the VAT rate" (see figures **10** and **11**).

This funding strategy would be consistent with the Davis Tax Committee's assessment that in terms of longer term implications for the economy, an increase in the VAT rate would be less damaging compared to increases in personal or corporate income taxes. Specifically, the Committee found that

Figure 10: Personal income tax rates



Source: KPMG

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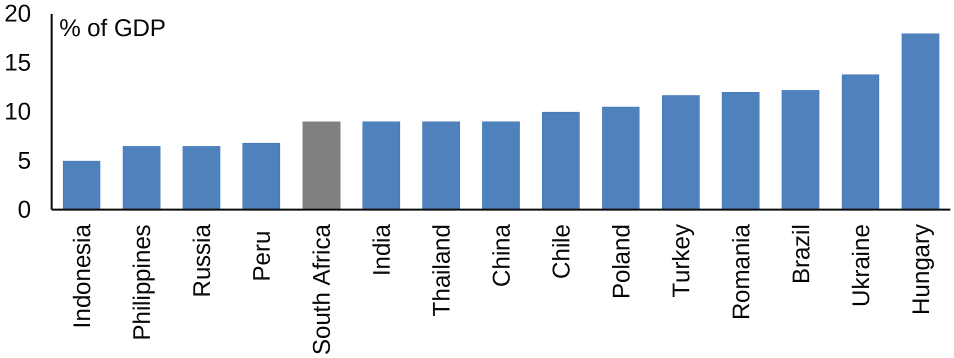
Figure 11: Consumption taxes



Source: KPMG

raising R45bn in tax revenues could be derived from a 3.0% increase in the VAT rate or a 6.1% increase in personal income tax rates or a 5.2% increase in corporate income tax. However, it is unclear whether this would be considered, particularly in the lead up to the 2019 election.

Adjustments on the expenditure front, similar to the 0.4% of GDP reductions announced in the Budget, will also be necessary to resume the path of fiscal consolidation over the medium term. The MTBPS will have to signal an adherence to the nominal expenditure ceiling and intentions to reduce the ceiling further over the medium-term. The main measures taken to contain spending within the expenditure ceiling will likely continue to include the reprioritsation of expenditure; cost containment measures on non-essential goods and services; procurement reforms and limits on compensation.

With regard to compensation, the MTBPS is expected to reiterate efforts to restrict both civil servant hiring and the growth in compensation expenditure (see figure 12). The Budget allows for compensation expenditure growth of 7.2% over the medium term. Compensation expenditure absorbs a sizeable share of total current expenditure, of 35%, "without a commensurate increase in productivity" according to the 2016 Budget. The outcome of the 2017/18 wage negotiations poses a potential risk if the settlement occurs in excess of the Budget estimate. Wage bill pressures could threaten the expenditure ceiling and/or the composition of government spending.

In view of the heightened risk of further sovereign credit rating downgrades, the medium term outlook presented in the MTBPS is expected to demonstrate some degree of fiscal consolidation and a

Figure 12: Emerging market public sector wage bill

Source: IMF

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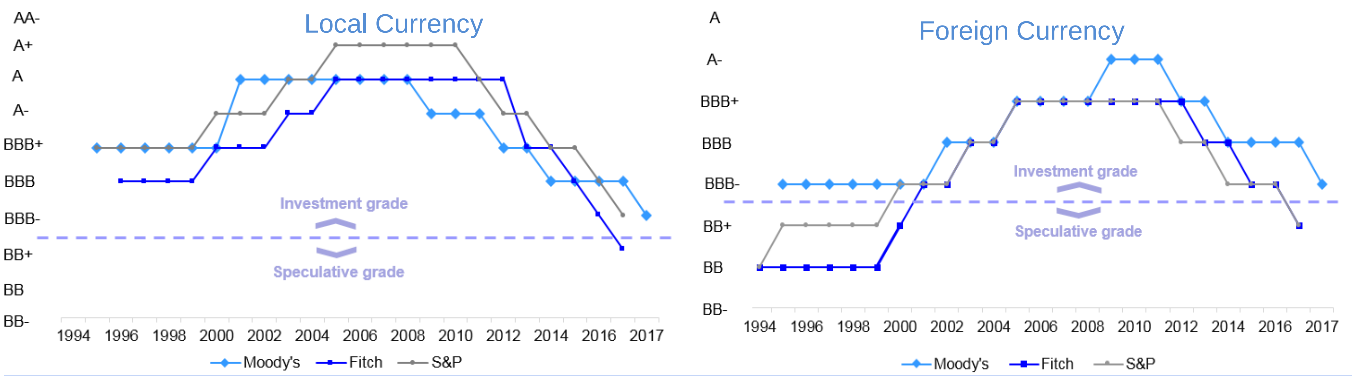
Figure 13: South African local and foreign currency long-term sovereign credit ratings



Source: Rating agencies

stabilisation of debt ratios. As a point of reference, National Treasury has expressed a commitment to fiscal consolidation plans on a number of occasions over the past few months. South Africa's local currency credit rating with Moody's and S&P is one notch above non-investment grade and the outlooks are negative. SA's rating with Fitch is one notch below investment grade but with a stable outlook (see figure 13).

Should the MTBPS deliver on fiscal consolidation it is unlikely that SA would receive a further downgrade at the next scheduled credit rating reviews at the end of November. However, the outcome of the ANC elective conference in December could inform SA's credit rating in 2018 in terms of how it translates to economic and fiscal policy and therefore economic growth.

A credit rating downgrade by both S&P and Moody's of the local debt rating would see SA exit key global bond indices, with forced selling by foreigners estimated at around US$10bn (see figure 14). Although only 10% of government debt is denominated in foreign currency, non-residents hold 40% of government's rand denominated debt which heightens SA's external vulnerability (see figures 15 and 16).

Figure 14: Selected global bond indices

Index	Inclusion criteria	Current status
Citibank World Government Bond Index (WGBI)	IG local currency rating from S&P or Moody's	Included
Barclays Global Aggregate	IG local currency rating from any two agencies	Included
JPMorgan EM Bond Index Global (EMBIG) IG	IG foreign currency rating from any two agencies	Excluded from 28 April 2017
JPMorgan Government Bond Index EM Global Diversified IG and IG only Emerging	IG local currency rating from all three agencies	Excluded from 31 May 2017
JPMorgan Government Bond Index – EMs (GBI-EM)	No ratings criteria but EMs must have no impediments for foreign investors	Included

Source: SA Reserve Bank

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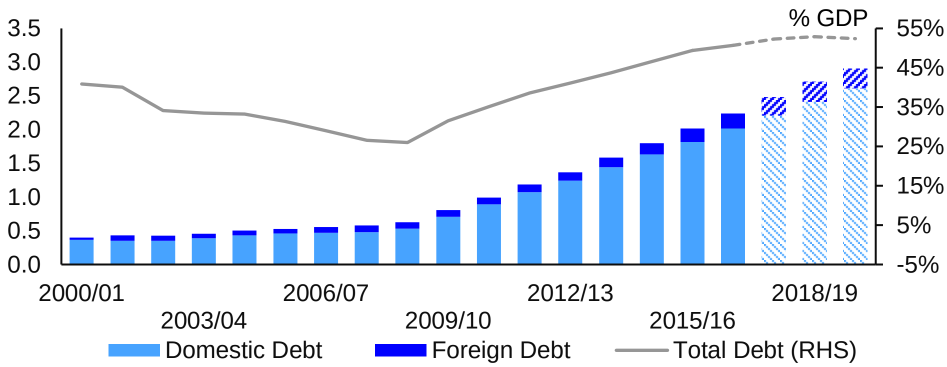
Figure 15: Total government debt



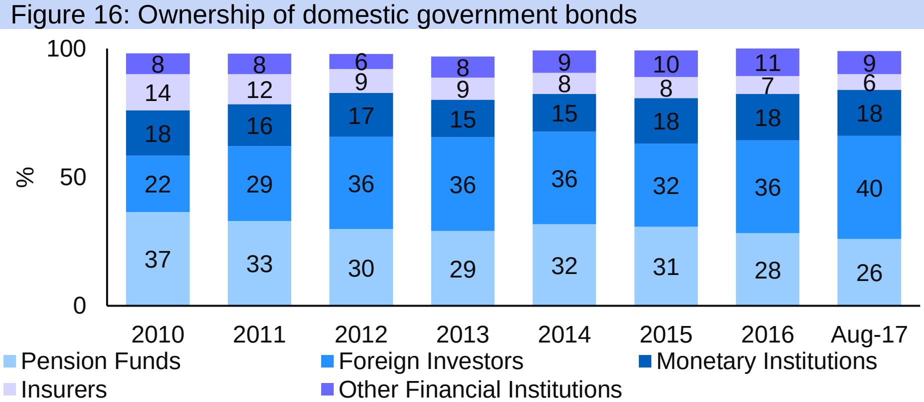
Source: National Treasury

Achieving a stabilisation of debt ratios will partly rely on addressing the sizeable fiscal risks associated with the realisation of contingent liabilities and/or recapitalisation of state-owned enterprises (SOEs). Government's major contingent liabilities relate to its guarantees. In the event of default by an SOE, the government may be called upon to fund the portion of the guarantees it has exposure to.

Government contingent liabilities have risen since 2008/09, reflecting the deterioration in the balance sheet position of several SOEs and the absence of structural reform in governance and management of SOEs (see figures 17 and 19). Specifically, guarantees to public institutions have risen from R298.4bn in 2009/10 to R477.7bn in 2016/17. Over the same period, exposure (the amount that SOEs have borrowed against the guarantees) increased from R129.1bn to R308.3bn. The IMF has estimated that rising contingent liabilities in SOEs could push government debt levels from 51% of GDP presently to above the high-risk benchmark of 70% of GDP (see figure 18).

The largest guarantee of R350bn is provided to Eskom. According to Eskom's 2017 integrated report, by March 2017 Eskom utilised R254bn of the guarantees with a further R84bn awaiting approval. With over two-thirds of the guarantees used up and with the utility under financial pressure following, amongst others, only a 2.2% tariff increase granted by NERSA this year, National Treasury has offered support as per Finance Minister Gigaba's 14-point inclusive growth action plan announced in July. The plan only made reference to developing "the case for Eskom soft support until tariff adjustment in 2018

Figure 16: Ownership of domestic government bonds



Source: National Treasury

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Figure 17: Government guarantee exposure

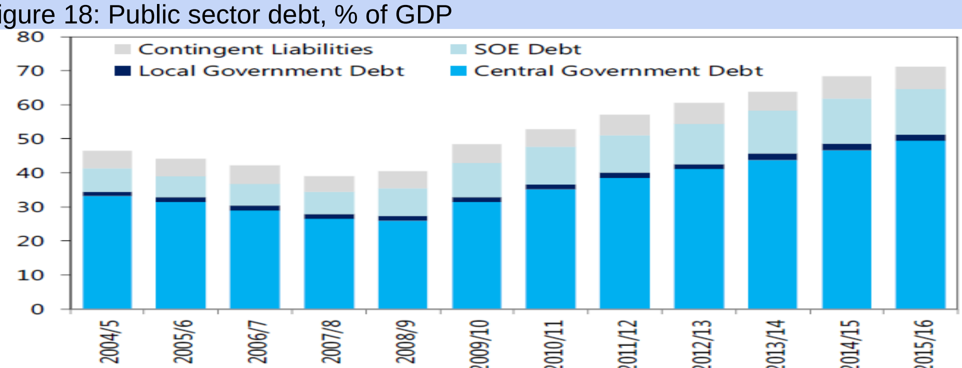
	2009/10		2016/17	
R billion	Guarantee	Exposure	Guarantee	Exposure
State-owned companies	**298.4**	**129.1**	**477.7**	**308.3**
of which:				
Eskom	*176.0*	*46.7*	*350.0*	*218.2*
SANRAL	*38.9*	*12.3*	*38.9*	*30.1*
Trans-Caledon Tunnel Authority	*25.6*	*20.7*	*25.7*	*20.7*
South African Airways	*1.6*	*1.4*	*19.1*	*17.9*
Land Bank	*3.8*	*2.6*	*11.1*	*5.4*
Development Bank	*29.3*	*26.6*	*12.7*	*4.2*
South African Post Office	-	-	*4.4*	*3.9*
Transnet	*11.4*	*11.6*	*3.5*	*3.8*
Denel	*1.9*	*1.9*	*1.9*	*1.9*
South African Express	-	-	*1.1*	*1.0*
Industrial Development Corporation	*1.6*	*0.9*	*1.9*	*0.2*
South African Reserve Bank	*7.0*	-	*3.0*	–
Independent power producers	**-**	**-**	**200.2**	**125.8**
Public-private partnerships[3]	**-**	**-**	**10.9**	**10.9**

Source: National Treasury

and submit to Treasury and Eskom Board". Details of what such support would entail are expected to be outlined in the MTBPS. If the support involves further guarantees, and therefore increased contingent liabilities, this would be negative from a fiscal perspective.

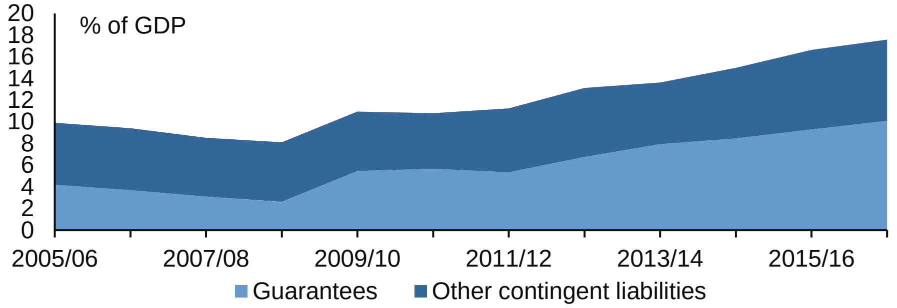
The Finance Minister also indicated that SAA has used up R18.6bn of its total government guarantees of R19.1bn. SAA's liquidity constraints saw the extension of R2.2bn and R3.0bn bailouts for SAA in July and September 2017 respectively. In addition to this amount, SAA has indicated it requires in the region of a further R13bn over the next three years. The Treasury confirmed that in terms of the recapitalisation of SAA "(s)everal options are being explored and an update will be provided during the" MTBPS. The previous National Treasury leadership had maintained the policy stance that "any intervention to support state-owned companies must be deficit neutral. Entities receiving support from government will be required to provide sound business plans, improve governance and address

Figure 18: Public sector debt, % of GDP



Source: IMF

Figure 19: Contingent liabilities



Source: National Treasury

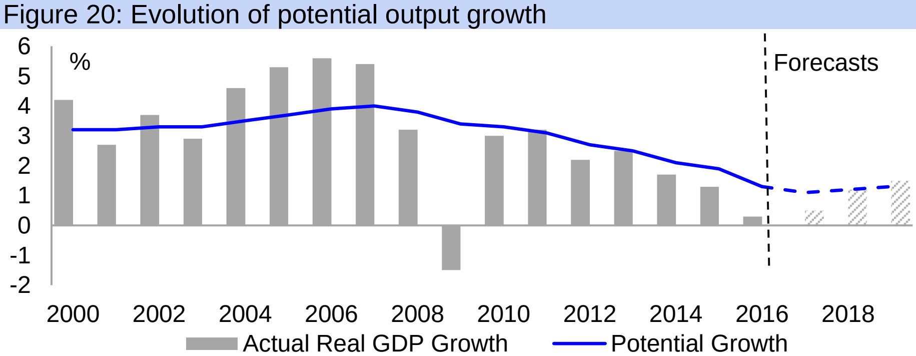
operational inefficiencies." The bail-out plan for SAA would have to be in line with this policy stance in order to be assessed as credible by the rating agencies.

Given that government guarantee exposure to SOEs is already a key sovereign credit rating weakness, owing to the weak performance of the SOEs, broader SOE reform is necessary. On SOE reform, the IMF advises "(a) strong governance framework, including transparency surrounding board appointments and remuneration of board members and management, and stronger accountability are essential to improve efficiency and ensure incentives are aligned with those of the country." Greater private participation has also been recommended to "help improve efficiency and service delivery, and free up resources for SOEs' investments."

Another critical concern of the ratings agencies pertains to economic growth prospects given the implications for fiscal consolidation. Weak economic growth weighs on tax revenue growth and increases the likelihood that the year in which debt stabilises is pushed out. Debt was estimated to stabilise at 53% of GDP in 2018/19 and recede thereafter but it is likely that at this rate debt levels will rise further towards 55% in this time frame.

The MTBPS will highlight the difficulty in accomplishing its fiscal goals in the absence of an economic growth recovery. As the IMF has assessed "implementation of pro-growth structural reforms would be the best sustainable way to ensure an improved fiscal outlook over the medium term." However, Moody's recently cautioned that "in the run up to the elections the commitment to difficult (and hence less popular) reforms aimed at promoting growth and consolidating government finances has been weakening." Effective policy implementation and the enhancement of policy certainty are required to restore business confidence and enhance the investment climate which would ultimately lift potential GDP growth (see figure 20).

Figure 20: Evolution of potential output growth



Source: SA Reserve Bank, Stats SA

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