Investec

Budget Review 2024

How to sidestep a fiscal cliff on the near horizon

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Introduction

The February 2024 budget was primarily aimed at fiscal consolidation amidst sluggish economic growth. The increasing debt trajectory, coupled with high funding costs due to a substantial gross financing need and elevated country risk premium, prompted the National Treasury to activate the Government Finance Emergency Contingency Reserve Account (GFECRA). By deploying GFECRA, R150 billion will be distributed to the National Treasury, which is expected to reduce debt servicing costs by R33 billion over the Medium-Term Expenditure Framework (MTEF) period.

Although the GDP growth rate is forecasted to improve to 1.3% in 2024 from an estimated 0.6% in 2023, partly thanks to reduced load shedding and anticipated interest rate cuts in the second half of 2024, this level of growth remains insufficient. More robust economic expansion is necessary to stimulate private sector fixed investment and employment. Emphasis has also been placed on the private sector's involvement in improving South Africa's infrastructure. The urgency of accelerating reforms is highlighted, as the use of GFECRA is seen as a temporary measure to maintain financial stability while awaiting the acceleration of economic growth.

The application of GFECRA funds has enabled the National Treasury to redirect savings from debt servicing towards the public sector wage bill, particularly in labour-intensive departments. However, there is concern regarding the reduction in the capital expenditure (capex) budget throughout the MTEF period, despite the fact that its average growth rate of 10% outpaces the current spending growth rate of 5%.

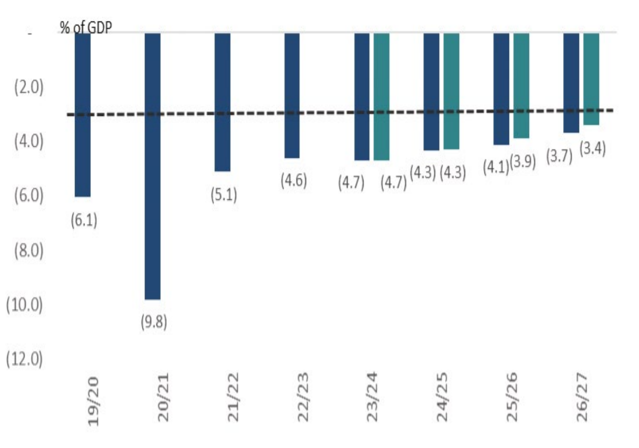
Fiscal metrics are looking better but rerating not yet on the cards

The fiscal forecasts for the main budget revenues and expenditures for F23/24 were largely consistent with the projections set out in the Medium-Term Budget Policy Statement (MTBPS) 2023. However, there is a risk associated with the forecast due to the assumption that there will be a significant reduction in spending in the first quarter of 2024, as the MTBPS was only enacted in January. Despite this, the projected main budget deficit remains unchanged at 4.7% of GDP.

For the financial year 2024/25, the projections follow a similar pattern to those in the MTBPS 2023, with the main budget deficit expected to hold steady at 4.3% of GDP. However, there is an anticipated improvement in the deficit in the later years of the Medium-Term Expenditure Framework (MTEF) period. This improvement is attributed to the secondary effects of the utilisation of the Government Finance Emergency Contingency Reserve Account (GFECRA), which includes a reduction in the borrowing requirement and debt servicing costs relative to the MTBPS forecast. Consequently, the main budget deficit is expected to decrease to 3.9% (previously projected at 4.1%) and 3.4% (previously projected at 3.7%) of GDP for the fiscal years 2025/26 and 2026/27, respectively.

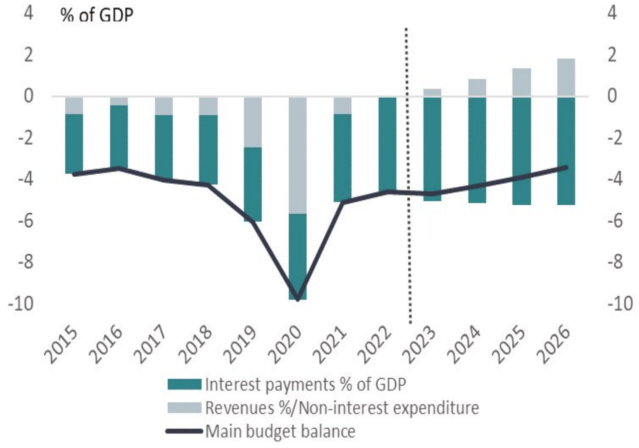
The gross debt-to-GDP ratio is projected to be 2.8% lower than previously forecasted, landing at 74.7% of GDP in the fiscal year 2026/27. Debt servicing costs are expected to stabilise at 21.1% of revenue, which remains high but shows a slight improvement from the 22.1% forecast in the MTBPS. This indicates that the financial strategies implemented, including the utilisation of GFECRA, are having a positive impact on the country's fiscal health, particularly in terms of managing debt levels and servicing costs.

Fig 1: Main budget deficit shows GFECRA effect in outer years of the MTEF period



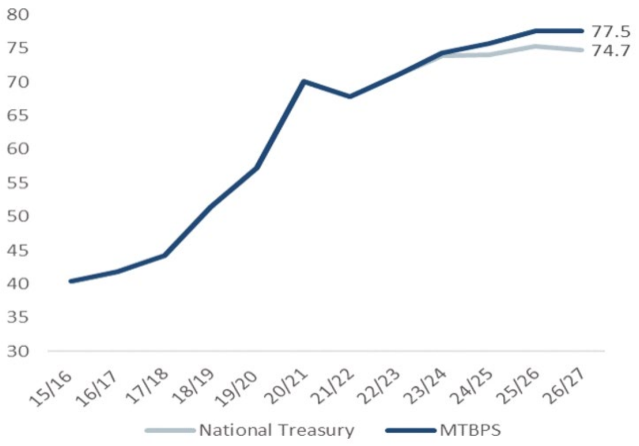
Source: Budget Review 2024, ICIB

Fig 2: Main budget deficit with the "de facto" primary surplus and interest payments



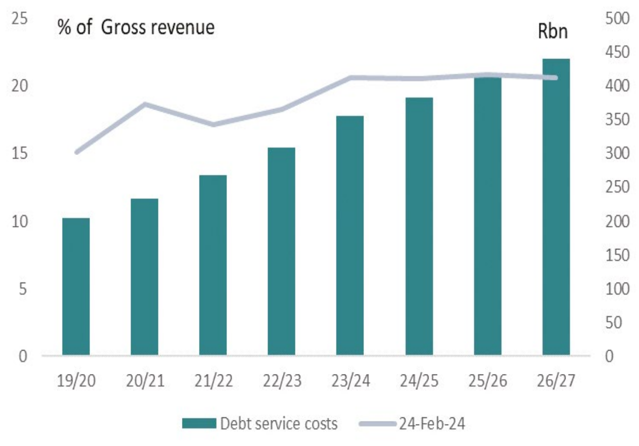
Source: National Treasury, ICIB

Fig 3: Gross debt to GDP ratio is 2.8% lower at 74.7% of GDP by by F26/27



Source: Budget Review 2024, ICIB

Fig 4: Debt servicing costs as % of gross revenue receipts



Source: Budget Review 2024, ICIB

Developments around key issues we were watching

- Gold and Foreign Exchange Reserve Contingency Account (GFECRA).
- Infrastructure financing and Public Private Partnerships.
- Transnet.
- Expenditure and reconfiguration of the state.
- Fiscal anchor.
- Two-pot pension system.
- Funding strategy.

GFECRA will be distributed

The unexpected announcement to utilise the Government Finance Emergency Contingency Reserve Account (GFECRA) to diminish the borrowing requirement has caught South African investors by surprise, as they were anticipating a clear signal from the Minister of Finance. The National Treasury plans to use a total of R150 billion from GFECRA over the Medium-Term Expenditure Framework (MTEF) period, with allocations of R100 billion, R25 billion, and R25 billion in fiscal years 2024/25, 2025/26, and 2026/27, respectively.

The South African Reserve Bank (SARB) and the National Treasury are in the process of formulating a proposed settlement agreement to devise a new framework aimed at reducing government borrowing and bolstering the SARB's equity position. This framework will consist of three "buckets":

- **Bucket 1:** GFECRA will maintain adequate funds to account for currency fluctuations. While the buffer size has not been finalised, it is currently approximated at around R250 billion. The right-sizing of this bucket will evolve over time and will be influenced by movements in the currency exchange rates. The National Treasury will be responsible for covering any foreign exchange (FX) losses.
- **Bucket 2:** The SARB will receive a contingency reserve of R100 billion, which is intended to ensure its solvency and cover sterilisation costs that arise from neutralising the liquidity effect.
- **Bucket 3:** The remaining funds, approximately R150 billion, will be distributed to the government. This distribution will take into account the liquidity conditions in the money market.

Various potential uses for the GFECRA were identified, including a one-time transfer for recurrent expenditure, creating a cash buffer in government deposits at the SARB, incorporating it into the financing strategy, and as part of a broader fiscal strategy that emphasises sustainable growth and fiscal sustainability. Ultimately, the government chose to utilise GFECRA to reduce the borrowing requirement and to support an incremental increase in the public sector wage bill over the MTEF period. This decision is made while awaiting the materialisation of infrastructure reforms, which may take several years to yield tangible results.

Effective tax rate of individuals continue to rise as bracket creep becomes a fixture over the MTEF period

The MTBPS has outlined a proposed tax increase of R15 billion. In line with expectations, the government has once again opted not to adjust personal income tax brackets for inflation, a strategy that has been used to generate additional revenue. This measure is expected to raise R16.3 billion in revenue, following a similar yield of R15 billion in the fiscal year 2023/24. Additional revenues as medical tax credits, are projected to contribute R1.9 billion, and excise duties to bring in R0.8 billion. Bracket creep has been a recurring method for raising revenue, having been employed in the years 2017, 2018, 2022, and 2023, and it is anticipated to continue over the MTEF period without any assumed adjustments to the tax brackets.

Other factors that are expected to contribute to tax buoyancy remaining above 1 include an upward revision to compensation growth and the implementation of the two-pot retirement tax reform. This reform allows for once-off withdrawals from retirement funds, which are subject to marginal tax rates. The forecasts for these once-off withdrawals range between R20 billion to R40 billion. The National Treasury is assuming that withdrawals totalling R27 billion could generate R5 billion in personal income tax (PIT) in the fiscal year 2024/25.

These measures reflect the government's strategy to bolster tax revenues in order to manage the budget deficit and finance public spending, while also navigating the challenges of economic growth and fiscal sustainability.

Lifting the growth trajectory through private sector involvement in infrastructure investment and financing

The revitalisation of South Africa's infrastructure is increasingly reliant on the active participation of the private sector. The Budget Review highlighted the critical issues of energy supply and logistics, noting that these are being tackled through initiatives designed to expedite private investment in infrastructure while simultaneously stabilising key state-owned enterprises (SOEs) such as Eskom and Transnet. The private sector's involvement is gaining traction, particularly with business representatives joining pivotal committees like the National Energy Crisis Committee (NECOM) and the National Logistics Crisis Committee (NLCC). These committees aim to leverage the private sector's skills and capital to rejuvenate the country's infrastructure.

Over the next three years, the public sector's total infrastructure investment is expected to reach R943.8 billion, with the breakdown as follows:

- SOEs: R486.1 billion
- Municipalities: R213.8 billion
- Provincial and national government: R224.8 billion

The government recognises the need to not only increase the volume of infrastructure delivery but also improve its quality. To achieve this, it is looking to mobilise private sector financing and technical expertise on a significant scale. Some of the institutional reforms underway to support this objective include:

- The creation of an infrastructure finance and implementation support agency, set to be established in the fiscal year 2024/25. This agency's role will be to centralise the financing, preparation, and planning of large-scale projects with the aim of attracting private sector finance and expertise.
- The increased use of Public-Private Partnerships (PPPs) to execute infrastructure projects. An overarching Public Investment Management (PIM) policy is currently being developed to govern PPPs and other blended finance initiatives.

Transnet

National Treasury has decided against a direct cash injection for Transnet. Instead, a guarantee was granted in December 2023, which Transnet can use to manage its maturing debt and implement the turnaround plan. From December 2023 to March 2024, Transnet has already made use of R14 billion from the guarantee. This funding has been applied to repay maturing debt and to ensure that short-term initiatives within the recovery plans are set in motion. Transnet is required to undertake several measures to improve its financial position, including the sale of non-core assets and reduce its current cost structure. Development finance institutions are expected to become an important source of financing in coming years.

Fiscal anchor

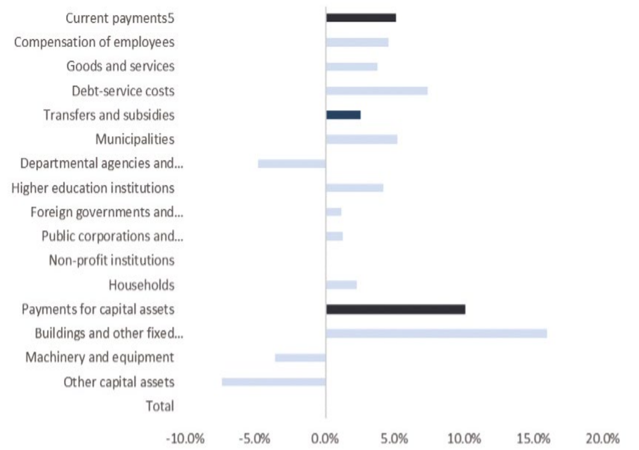
The National Treasury's plan to enter into consultations regarding a binding fiscal anchor in 2024 reflects a commitment to reinforce fiscal discipline and stability within South Africa's public finances. There will be consultations in 2024. Before such an anchor can be enacted into law, it must be approved by the Cabinet. The primary budget surplus is used as a de facto anchor in the interim. A legislated fiscal anchor will contribute to an improvement in investor confidence.

Expenditure and reconfiguration of the state

Besides the risk to the expenditure projection in F23/24, government has mostly stayed the course with plans to reduce non-interest expenditure by R80.6bn. Some of the reductions announced in the MTBPS have been reversed due to the distribution of GFECRA and the decline in debt servicing costs. In the consolidated budget, while capex spending is forecast to grow by 10.0% per annum over the MTEF period, spending in absolute terms was slashed by R31.6bn. The increase in debt servicing costs has been reduced to an average of 7.3% (previously 8.7%).

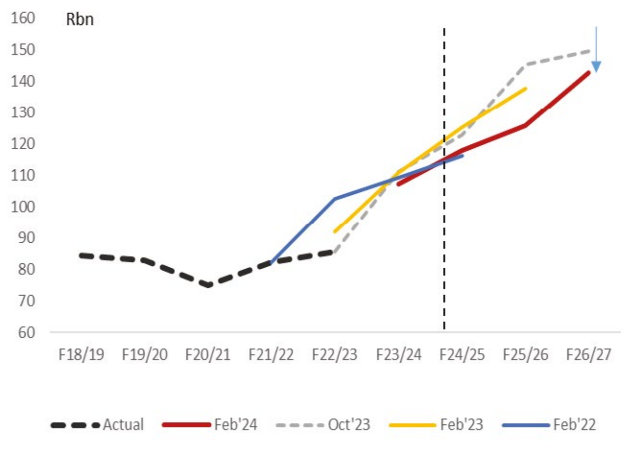
Reconfiguration of the state: Very little new information has been forthcoming about the reconfiguration of the state. This involves restructuring the size and shape of the state while enhancing its ability to provide high-quality public services. The implementation of these changes is projected to occur following the 2024 elections. However, these promises were already made at the start of President Ramaphosa's first term.

Fig 5: Consolidated government expenditure by economic classification



Source: Budget Review 2024, ICIB

Fig 6: Cutbacks in capex budget



Source: Budget Review 2024, ICIB

Progress reports

Eskom update: The disbursement to Eskom has been reduced by R2bn per annum to R76bn and R64.1bn in F23/24 and R24/25 as the disposable of Eskom Finance Company, stipulated in the debt relief conditions, has not been concluded.

Municipal application for debt relief owed to Eskom: This is part of the debt relief to Eskom as nonpayment of services has a material impact on revenues. 72 municipalities have applied for debt relief by December 2023. This accounts for 96.9% of the total debt owed to Eskom in March 2023. A phased approach will be used to write off debt, starting with 33% in the first year if a debt reduction has been achieved. Failure to meet the target in electricity supply is cut off.

What is next?

- General election on the 29th of May.
- Transnet:
  - Leadership appointments at Transnet
  - Introduction of third-party access to the freight rail network by May 2024:
  - Finalise partnerships with a private company by April 2024 to upgrade Pier 2 of the Durban container terminal.
- Short-term options for off-balance sheet financing to Eskom to accelerate private sector investment in transmission. A pilot project will be implemented to test the market appetite for the proposed option, with a request for proposals expected to be issued at the end of July 2024.

Financing of the gross borrowing requirement

GFECRA and the country-risk premium

We noted in our Budget Preview that the financing strategy is challenged by the high cost of funding and the issuance of low-coupon bonds. The increase in the discount on SAGB funding bonds from R20bn to R60bn in F23/24 has led to a larger reliance on FRNs (R66bn) and a new rand Sukuk bond (R20bn). The borrowing requirement has decreased by R98bn from R560bn to R458bn due to the distribution of GFECRA. The mix of funding is forecast to consist of the following:

T-bill issuance: The net increase is set at R33bn. National Treasury projects a net increase of R88bn in F23/24. The increase in F4/25 indicates that the size of weekly auctions will rise during the year.

Long-term bond issuance: Cash generated from long-term bond issuance is forecast at R328bn, which is unchanged from R330bn in F23/24. National Treasury announced that the quantum of weekly SAGB auctions will be reduced by R150m to R3.75bn, which amounts to R7.8bn over the 52 funding weeks. The non-competitive allocations have been increased from 50% to 75%. In the primary market, the allocation was increased from 20% to 30% and from 30% to 45% on the the ETP platform. The latter is likely to be an attempt to boost liquidity. The term to maturity of the total is forecast to decline to

10.7% from 11.2 years. However, this can be ascribed to a decline in bond issuance relative to the MTBPS forecast. Switch auctions will continue as 20% of long-term debt matures in five years. The quantum of FRNS issued could decline to ~R37bn, and the National Treasury has not yet decided to issue another rand Sukuk bond.

Foreign loans of $2bbn will be issued to finance a redemption of R40.5bn. National Treasury has reduced government deposits denominated in foreign currency from $7.1bn in F22/23 to $4.6bn in F23/24, with a further decrease to $2.1bn projected for F24/25. Funding from DFI or multi-lateral agencies is preferred, due to lower funding costs.

Bond market dynamics: Longer-dated yields have rallied by ~20bps over the past two days. The SAGB yield curve has flattened by ~20bps over the past two days, of which ~10bps materialised post the GFECRA announcement. Domestic investors expected an increase in bond issuance. However, funding bonds will continue to comprise maturities from 2035 and longer, with more supply emanating from switch auctions. Added to this will be growth dynamics, which is the critical ingredient for a sustained reduction in the risk premium and the return of foreign investors. However, we are of the view that the upside risk to SAGB yields has declined, but the outcome of the election on the 29th of May remains a risk event. Our fair value on the generic 10yr SAGB yield is 10.7% on the assumption of constructive election outcome.

Fig 7: Financing of national government gross borrowing requirement[1]

	2022/23	2023/24		2024/25	2025/26	2026/27
R bn	Outcome	Budget	Revised	Medium-term estimates		
Main budget balance	-309,9	-275,4	-331,4	-320,9	-308,2	-287,2
Redemptions	-90,3	-162,2	-145,8	-172,6	-185,6	-166,3
Domestic long-term loans	-74,6	-117,9	-98,6	-132,1	-126,7	-126,7
Foreign loans	-15,8	-44,4	-47,1	-40,5	-58,9	-39,6
Eskom debt-relief arrangement	–	-78,0	-76,0	-64,2	-110,2	–
GFECRA settlement (net)[4]	–	–	–	100,0	25,0	25,0
Total	-400,3	-515,6	-553,1	-457,7	-579,0	-428,5
Financing	–	–	–	–	–	–
Domestic short-term loans	-25,6	48,0	88,0	33,0	47,0	34,0
Domestic long-term loans	322,4	329,9	327,9	328,1	422,2	303,2
Market loans	321,7	329,9	328,0	328,1	352,2	303,2
Eskom debt-relief arrangement	–	–	–	–	70,0	–
Foreign loans	64,5	44,4	45,2	36,7	82,2	92,2
Change in cash and other balances[2]	39,0	93,3	92,1	59,9	27,6	-0,9
Total	400,3	515,6	553,1	457,7	579,0	428,5

Source: National Treasury, ICIB