

Comment

MTBPS: Political straightjacket delays any significant fiscal decisions

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Introduction

In his first, and potentially only, budget policy speech, Minister Gigaba presented an “honest” assessment of SA’s poor macroeconomic outlook and - in the absence of corrective measures - the dire consequences this will have for the fiscal balances.

This was not a business as usual Medium-Term Budget Policy Statement (MTBPS) as the Treasury effectively postponed any major fiscal decisions to the February 2018 Budget at the earliest. By then, there will hopefully be greater clarity on the country’s future political leadership. Against expectations, no major (additional) revenue-raising or expenditure-control measures were announced to alleviate the worsening fiscal situation.

Instead, government plans to borrow more to finance a gross government debt burden that is expected to now reach a worrying 61% of GDP by 2020/21. It is as though Treasury wanted to demonstrate, in no uncertain terms, to their Cabinet colleagues what the implications would be if they fail to implement confidence and growth-boosting reforms. Treasury officials argued that focused fiscal consolidation needs strong leadership, which is severely lacking in the lead-up to the ANC’s elective conference in December. On one level, we have sympathy for this approach and applaud the reality check it provides to the country. However, in our view presenting such a fiscal deterioration is a high-risk strategy that materially raises the prospect of further credit rating downgrades. In a scenario of further downgrades, the mountain to climb towards fiscal recovery will be that much steeper.

The Treasury also seems to be gambling on a continuation of favourable global economic conditions. This would presumably encourage foreign investors to fund higher domestic deficits. Again, we view this as a strategy with high risk.

Macroeconomic outlook reflects severe growth challenges

The Treasury’s revised macroeconomic forecasts are set out in [Table 1](#). Relative to the February budget, the forecast for **real GDP growth** has been revised down significantly. Treasury now expects growth to average 1.1% over the 2017-19 period, a downward revision of 0.7 percentage points (%pts). Treasury expects growth to measure 0.7% in 2017, before picking up slowly to reach 1.9% in 2020. The downward

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Please refer to the [glossary on the BER’s website](#) for explanations of technical terms.

revision reflects the significant deterioration in business and consumer confidence witnessed over the past 12 to 18 months, as well as weaker than expected growth outcomes in the fourth quarter of 2016 and the first quarter of 2017. It also flows from heightened risk perceptions as indicated in credit rating downgrades, higher bond yields and sluggish investment growth. In contrast to the overly optimistic outlook presented in the February budget, the latest numbers are in line with the BER's muted expectations. We expect real growth to average 1% between 2017 and 2019, with real GDP also projected to expand by 1.9% in 2020. While improving global demand and higher commodity prices should provide some support over the medium term, domestic factors such as low business confidence and high levels of policy uncertainty are expected to continue to weigh on real GDP growth over the forecast horizon.

Table 1: Significant downward revision to macroeconomic outlook

	Feb '17 Budget				Oct '17 MTBPS				
	2017	2018	2019	Ave '17-'19	2017	2018	2019	Ave '17-'19	2020
Real GDP growth	1.3	2.0	2.2	1.8	0.7	1.1	1.5	1.1	1.9
CPI inflation	6.4	5.7	5.6	5.9	5.4	5.2	5.5	5.4	5.5
Nominal GDP growth	7.8	8.0	8.2	8.0	6.1	6.2	6.8	6.4	7.5
Current account (% of GDP)	-3.9	-3.7	-3.8	-3.8	-2.3	-2.6	-2.9	-2.6	-3.1

Source: Budget Review, MTBPS 2017

Treasury's forecast for **nominal GDP growth**, which is more important from a government revenue perspective, was also revised down. This is in line with a lower inflation profile and the weaker outlook for the real economy. The forecast for the GDP price index (deflator) was revised down by an average of 0.9 %pts over the 2017-19 period, which, combined with the lower real GDP growth forecast, resulted in a 1.6 %pts downward adjustment in the outlook for nominal GDP growth. While Treasury's forecast arguably presents an honest assessment of SA's growth potential in the absence of key structural reforms, it does suggest that government revenue will come under significant pressure over the Medium-Term Expenditure Framework (MTEF, implying the next three fiscal years). We unpack this in the next section.

Treasury's outlook for **consumer inflation** (CPI) has also been revised down. CPI inflation is expected to average 5.4% over the 2017-19 period, in line with our own projection for an average of 5.3% over the same period. The revisions largely reflect lower oil and food prices, and a slightly stronger rand exchange rate assumption. Finally, an improved net export position, mainly due to stronger global demand and higher commodity prices, is projected to result in a narrowing of the **current account deficit** from 3.3% of GDP in 2016 to 2.3% in 2017. The deficit is expected to deteriorate marginally over the MTEF, reaching 3.1% of GDP in 2020.

National Treasury's baseline macroeconomic projections imply that per capita income will likely continue to stagnate in coming years and that, without decisive action, SA could be heading for a low-growth trap characterised by deteriorating growth, mounting government debt and rising unemployment. The MTBPS also includes a reference to several macroeconomic scenarios. The worst-case scenario sees the projected deterioration in the fiscal accounts leading to further credit rating downgrades and a significant worsening of growth prospects, resulting in even more fiscal slippage and explosive growth in government debt.

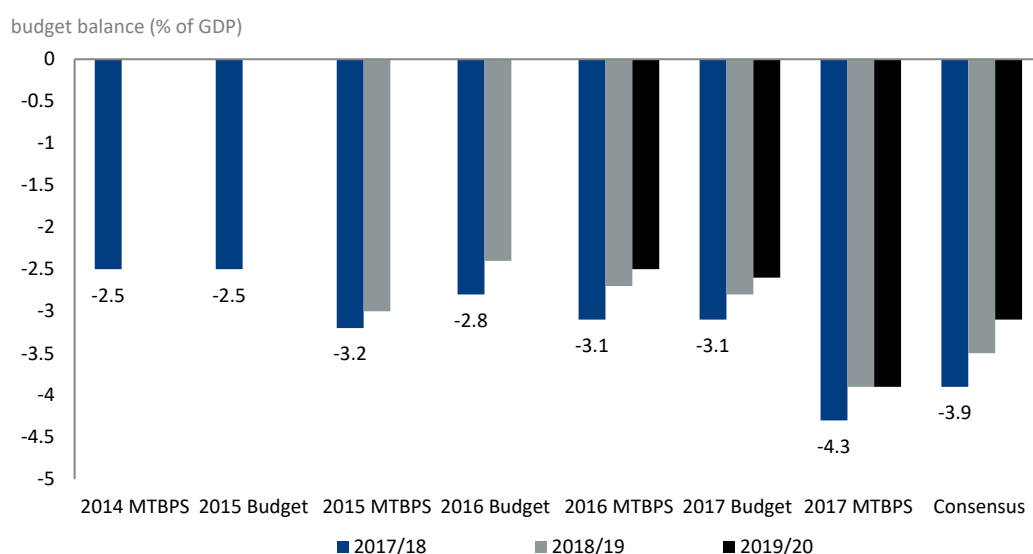
Disconcertingly, the political will to implement the reforms required to avert this scenario is expected to remain lacking, at least until the outcome of the December ANC leadership conference. Even then, there is no guarantee that the new ANC president will be in any position, or of the inclination, to implement said reforms.

While the MTBPS includes references to several initiatives aimed at reviving confidence and economic growth, progress has been stymied by political infighting and lacklustre implementation. Without a firm commitment to growth-enhancing reforms, combined with consolidation on both the revenue and expenditure side of the budget, the worst-case scenario outlined in the MTBPS becomes increasingly likely.

Notable fiscal slippage amid weak growth and absence of corrective measures

For some time, it has been clear that significantly softer revenue growth than projected in the February Budget would result in a wider budget deficit for the 2017/18 fiscal year. Indeed, one of many headline-grabbing numbers in the MTBPS is a revised revenue forecast for the current fiscal year that is R50.8bn lower than the February target. If realised, this would be the largest shortfall since the 2009 recession. As a result, the consolidated budget deficit is now estimated to amount to 4.3% of GDP, a sharp deterioration from the 3.1% of GDP projected in February.

Figure 1: Budget shortfall remains elevated throughout medium term



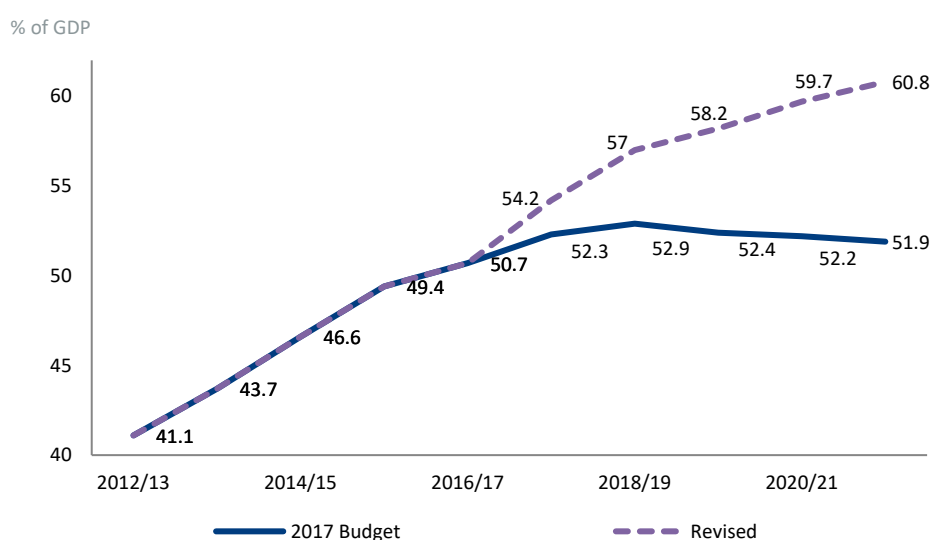
Source: MTBPS, Budget Reviews (2014 - 2017), Reuters

Figure 1 outlines the sustained downward adjustment to the 2017/18 budget deficit since a forecast for the current fiscal year was first made in October 2014. It is worth noting that at the time of the 2014 MTBPS, the Treasury expected real GDP growth of 3% in 2017. As outlined in [Table 1](#), this has been cut to 0.7%. The adjusted 2017/18 budget deficit is wider than the expectation of any of the 15 economists who participated in a recent Reuters poll. Of greater significance is that the Treasury's revised outlook indicates that the budget shortfall will remain elevated, averaging 3.9% of GDP between 2018/19 and 2020/21. As in 2017/18, the deterioration in the outer years is largely a function of a much weaker revenue outlook.

Combined, gross tax revenue for the 2017/18 to 2019/20 period is projected to be R209bn lower than was envisaged in the February Budget.

An additional factor in explaining the wider 2017/18 budget deficit is a R3.9bn breach of the expenditure ceiling. This relates to the recapitalisation of South African Airways (SAA) and the SA Post Office. Treasury aims to correct the breach through a government asset sale (most likely part of Telkom), but the details remain sketchy. The impact of the larger than previously expected budget shortfalls is that overall gross government debt is no longer expected to stabilise around 52% of GDP. Figure 2 outlines that in the absence of major corrective measures (further aggressive tax hikes and / or expenditure cuts), debt is projected to reach just below 61% of GDP by 2020/21.

Figure 2: Gross government debt rises through 2020/21



Source: MTBPS, 2017

Apart from reductions in the **expenditure ceiling** of R7bn in 2018/19 and R15bn in 2019/20 (mainly through a cut in the contingency reserve) and R15bn¹ worth of tax increases in 2018/19, Treasury announced no measures to prevent the sustained build-up of debt. The MTBPS mentions that government's short-term options to reverse this situation are limited. Given that per capita income is falling, the argument was put forward that the adverse economic impact of further expenditure cuts or tax hikes could be counter-productive. The implication is that, in order to finance the larger shortfalls, government will be forced to borrow more than was previously envisaged. By 2019/20, the revised estimate is for government to issue almost R70bn more debt than assumed in February. Predictably, the capital market was not pleased with this – the yield on the benchmark R186 government bond rose by more than 20bps on the day.

¹ The MTBPS assumes that annual adjustments to tax thresholds and brackets will be in line with the CPI inflation projections. This suggests that, after individuals were hit with a R16.5bn tax hike in 2017, only limited personal income tax hikes are likely in future.

A **Presidential task team** has been appointed to investigate measures to bring the public finances back to a sustainable path. Details will be provided in the 2018 Budget. In terms of recent indications that the Presidency will take over expenditure prioritisation in the budget process, the MTBPS briefly summarises the Department of Planning, Monitoring and Evaluation's Mandate Paper for the 2018 Budget. The highlights include:

- Maintaining the real growth in infrastructure spending
- Free education for the poor
- The implementation of **National Health Insurance**

It is not clear how these objectives are obtainable against the current fiscal backdrop. Indeed, the MTBPS projections for the major consolidated expenditure items indicate that current expenditure (including the public sector wage bill) is expected to be the fastest growing expenditure item over the MTEF (Table 2).

Table 2: Government spending remains dominated by current expenditure

Consolidated expenditure	Average MTEF growth (nominal %)	
	Budget 2017	MTBPS 2017
Current payments	7.7	7.9
Compensation of employees	7.2	7.3
Transfers	7.7	7.5
Capital assets	5.1	3.6
Total	7.9	7.3

Source: MTBPS, 2017

Regarding the proposed **nuclear programme**, Minister Gigaba's speech reiterated that implementation will take the economic climate and electricity demand into consideration and be done at a pace and scale that is affordable.

Strengthening SOE governance

Besides the general government finances, attention was also focused on any update on the progress regarding improved governance and balance sheets of state-owned enterprises. Not a lot was forthcoming, except that Treasury will soon propose measures to make the government guarantee framework for SOE's more stringent. This may include that additional guarantees will only be available to those SOE's able to demonstrate improved governance and operational efficiencies. In that vein, the MTBPS says that a new Eskom board, along with a credible management team, will be appointed by the end of November. For SAA, the plan is to consolidate government's aviation assets. Without providing any details, a strategic equity partner has also been identified to assist the airline.

While better qualified boards and management teams at SOE's is a welcome first step, it is not clear that the MTBPS sufficiently addressed the concerns surrounding rising SOE debt.

Ratings and forecast implications

The initial reaction from the rand exchange rate and government bonds suggest that financial market players interpreted the MTBPS as raising the risk of a further downgrade(s) to SA's credit rating. We share these concerns. In our view, the MTBPS has materially raised the prospect of local currency downgrades to sub-investment grade by S&P Global and Moody's. This would force SA out of the coveted World Government Bond Index (WGBI), with the potential for notable (albeit that the magnitude remains uncertain) foreign capital outflows from SA.

From this perspective, the MTBPS places strong downward risk to our October macro forecast. This mainly pertains to the rand exchange rate, although our long-held view has been that the currency would come under increased pressure from 2017Q4 onwards. Furthermore, our baseline forecast has been that there will be no further interest rate reduction – the MTBPS strengthens this view.

Relative to our current baseline forecast, the impact may be more severe on the real economy if further downgrades result in business and consumer confidence levels declining anew. The difficulty is that the timing of further downgrades remain uncertain as, despite the MTBPS deterioration, the agencies may still feel obliged to wait for the outcome of the upcoming ANC electoral conference in December before making a final decision. Furthermore, depending on the outcome in December, the fiscal outlook may be notably different in twelve months. From that perspective, it may be prudent for the rating agencies to extend the current wait-and-see approach a little bit longer.

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