

Comment

MTBPS: Concerning headline numbers, but with intent to shift to something more sustainable

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Introduction

In his maiden fiscal policy speech, Minister of Finance Tito Mboweni provided a strong statement of the steps SA needs to take in order to overcome our significant challenges. At first glance, there seems to be a disconnect between the prudent tone of the MTBPS speech and the fairly awful revised headline budget numbers. Relative to the February Budget, the MTBPS revealed significant slippage on the fiscal consolidation with overall government debt now expected to stabilise just below 60% of GDP.

However, beneath the surface the Treasury seems to have taken the initial steps to improve the composition of spending. Furthermore, the fiscal slippage should be seen as 1) mainly reflecting the impact of a revenue shock as the Treasury held the line on the expenditure ceiling with no additional spending allocations, and 2) against the backdrop of a very weak economy with the Treasury arguing that a pro-cyclical response of higher taxes/expenditure cuts would not be appropriate at this time. Perhaps of most importance is that, despite a public sector wage bill that exceeded the February Budget projection by R30bn, no additional money was allocated for this. Provincial departments must deal with the wage bill within their existing compensation ceilings. At the same time, spending reprioritisation sees some additional funds allocated for infrastructure investment.

The deterioration in the budget deficit numbers is largely a function of an increase in VAT refunds. While this is a clear negative from a deficit perspective, it could be seen as a stimulus to the real economy as companies and individuals will receive outstanding funds owed to them. Other important issues that received attention in the minister's speech include:

- An urgency to fix the **SA Revenue Service** (SARS). Additional funding of R1.3bn is provided to restore capacity at SARS, including an upgrade to IT systems.
- A clear statement of support for the independence of the **SA Reserve Bank** (SARB), including to reaffirm that the main mandate of the central bank is to keep inflation low and stable.
- The importance of restoring a culture of payment for services, including for toll roads and municipal services
- "Radical" measures need to be undertaken to deal with loss-making state-owned enterprises (SOEs). This could include the closure of the South African Airways.

24 October 2018

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

Despite these positive comments, the initial financial market response to the Medium-Term Budget Policy Statement (MTBPS) was negative as the focus was on the deterioration in the headline fiscal numbers. The higher debt trajectory, and a number of risks to the fiscal outlook, raise the risk of a Moody's sovereign credit rating downgrade in 2019. This would have a number of negative implications for the SA economy.

Weaker growth outlook amid global and domestic headwinds

The Treasury's revised macroeconomic forecasts are set out [Table 1](#). Relative to the outlook detailed in the February Budget, Treasury's forecast for real GDP growth has been revised down by an average of 0.3 percentage points (% pts) over the 2018-20 period. Treasury expects growth to measure a meagre 0.7% in 2018 (down from the 1.5% expected in February), before picking up to 1.7% in 2019 and gradually improving thereafter to reach 2.3% in 2021. This is broadly in line with our view of average growth of just over 1.6% over the four-year period. Treasury's forecast for nominal GDP growth, which is more important from a government revenue perspective, was revised down by an average of 0.2% pts over the 2018-20 period. The downward revision mainly reflects lower real growth – Treasury's forecast for the GDP price index (deflator) has remained unchanged at 5.6% over the 2018-20 period.

Table 1: Improved macroeconomic outlook

	Feb '18 Budget				Oct'18 MTBPS				
	2018	2019	2020	Average '18-'20	2018	2019	2020	Average '18-'20	2021
Real GDP growth	1.5	1.8	2.1	1.8	0.7	1.7	2.1	1.5	2.3
CPI inflation	5.3	5.4	5.5	5.4	4.9	5.6	5.4	5.3	5.4
Nominal GDP growth	7.3	7.2	7.7	7.4	6.4	7.4	7.7	7.2	7.7
Current account (% of GDP)	-2.3	-2.7	-3.2	-2.7	-3.2	-3.2	-3.7	-3.4	-3.9

Source:

Budget Review 2018, MTBPS 2018

Similarly, Treasury's outlook for **consumer price inflation (CPI)** remained largely unchanged relative to the February projection (see Table 1). Treasury expects headline inflation to average 4.9% in 2018, rising to 5.4% in 2021 as food price inflation returns to its historic average and administered prices, including electricity tariffs, record above inflation increases. Finally, Treasury expects a significant deterioration in the **balance of payments** over the forecast horizon, with the current account deficit expected to average 3.4% of GDP over the 2018-2020 period (2.7% in February) before deteriorating further to 3.9% of GDP in 2021. This is mainly a function of weaker terms of trade, with a higher oil price assumption interacting with the subdued outlook for SA's export commodity prices.

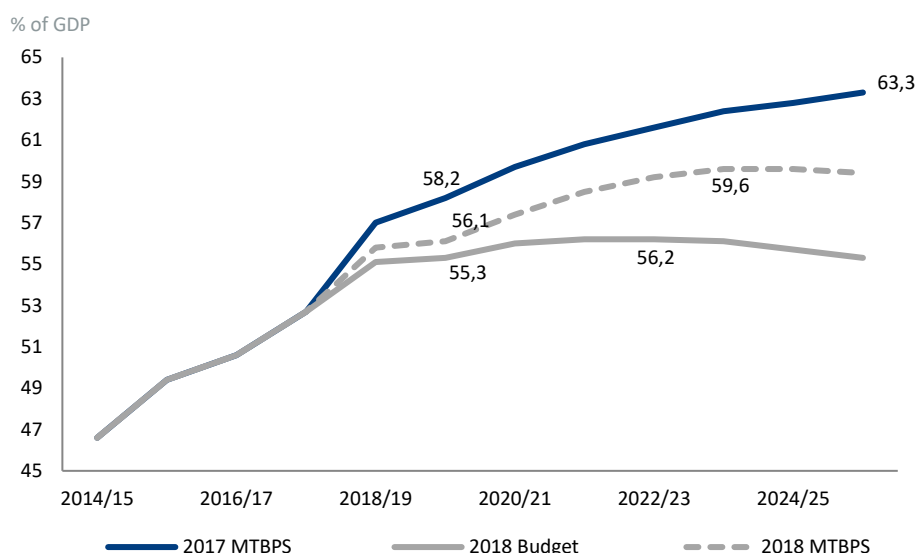
National Treasury's economic projections present a stark departure from the optimism reflected in February budget. The downward revision reflects a combination of both increased global headwinds and weak domestic activity. Increasing the economy's ability to grow sustainably at higher levels will require a series of reforms aimed at raising productivity, increasing competition and reducing the cost of doing business. Necessary structural reforms include: modernising the energy, water, transport and telecommunications sectors; lowering barriers to entry; enabling growth in labour-intensive sectors; promoting export competitiveness; and reducing the cost of doing business (including reducing transport

costs). Treasury estimates that such reforms could raise GDP growth by as much as three percentage points over the next decade. Over the short term, government has committed to establishing policy certainty, restoring investor confidence, and strengthening public institutions in order to boost the near-term growth outlook. However, recent developments on the policy front suggests that this is easier said than done and it remains to be seen whether President Ramaphosa's administration can follow through on the various proposals.

Revenue squeeze sees significant fiscal slippage

The headline-grabbing statistic of the MTBPS is illustrated in Figure 1. The revised estimate is for the **gross government debt** to GDP ratio to peak at 59.6% in the 2023/24 fiscal year. This presents a notable deterioration compared to the February Budget when debt was expected to stabilise at 56.2% during the 2021/22 fiscal year. A number of factors are at play here. In the current (2018/19) fiscal year, the Treasury says that the sharp weakening of the rand exchange rate since 2018Q2 accounts for more than two thirds of the increase in the debt ratio.

Figure 1: Revised estimates see gross debt stabilise at just below 60% of GDP



Source: Budget Review, MTBPS

Besides the weaker currency, the **consolidated budget deficit** projections for the current fiscal year and the medium-term expenditure period (next three fiscal years, or MTEF) have been revised up significantly. The details are provided in Table 2. On average, the budget shortfall between 2018/19 and 2020/21 is now expected to be 0.5% pts higher at 4.1% of GDP. This is much weaker than the Reuters consensus, which had an average deficit of 3.7% of GDP pencilled in for the 2018/19 - 2020/21 period. We expected slightly higher deficits than the consensus. Furthermore, in the latest edition of the **BER Weekly**, we emphasised that the risk was for a weaker-than-expected outcome.

Table 2: Medium-term consolidated budget projections

R billion	2018/19		MTBPS		Ave: 2018/19 to 2020/21		MTBPS
	Budget '18	MTBPS '18	2019/20	2020/21	Budget '18	MTBPS '18	2021/22
Budget balance	-180.5	-202.0	-226.4	-245.8	-192.9	-224.7	-251.1
% of GDP	-3.6	-4.0	-4.2	-4.2	-3.6	-4.1	-4.0

Source: Budget Review, MTBPS 2018

The higher deficit and debt trajectory is a function of much lower-than-expected revenue outcomes for both the current fiscal year and over the medium term. Relative to February, the revenue shortfalls amount to R27.4bn, R24.7bn and R33bn for 2018/19-2020/21. In 2018/19, R20bn of the revenue under recovery comes from lower value added tax (VAT) receipts. This relates to a large backlog of **VAT refunds** at SARS, and an underestimation of refunds due. This is still a legacy of the previous SARS regime under Tom Manyane. In addition, the projection for revenue from company tax has been reduced by almost R6bn. Of interest is that Treasury officials mentioned that after revenue held up well in the first five months (April to August) of the current fiscal year, the September data was weak and may signal the delayed impact of the very poor domestic GDP growth performance in the first half of 2018.

Going forward, the lower revenue projections are a function of slower growth in the tax base (a function of the weak GDP outlook) and a reduction in the **VAT tax buoyancy** to 1.0 from 1.1. In other words, the growth in VAT revenue is no longer expected to exceed the growth in the VAT tax base. The reduction in buoyancy is likely because of the higher-than-anticipated VAT refunds, as well as an increase in the number of zero-rated VAT goods. The MTBPS said that in response to the recommendations of the VAT review panel, white bread flour, cake flour and sanitary pads will be zero-rated from 1 April 2019. The estimated revenue loss of zero rating these goods is R1.2bn, but is (correctly in our view) seen as a way to restore the dignity of poor people. Finally, the MTBPS mentions that the revenue projections assume no change in tax rates in future. However, the normal inflation adjustment to personal income tax brackets and excise taxes will apply. No details were provided on any intervention to cap the rise in the domestic petrol price. Indeed, it was quiet the contrary with indications that the Road Accident Fund (RAF) Levy will need to increase sharply in coming years to fund the RAF's large liabilities.

On the expenditure side, the Treasury has stuck to the February Budget's nominal **expenditure ceiling**, which puts a cap on the amount that the government can spend. Nominal expenditure growth remains more or less in line with the February projections over the fiscal framework (see below for details). This is despite the **public sector wage deal** signed in February that exceeded the February projection by R30bn between 2018/19 and 2020/21. The expenditure numbers do not reflect the impact of the higher wage bill. The MTBPS mentions that there is a legally binding compensation ceiling for national departments, which has been kept unchanged over the MTEF. Therefore, departments are expected to absorb any shortfall within their current allocations through increasing efficiency, as well as managing overtime and performance incentives. In our view, this holds a key risk to the fiscal position as it is not clear that these measures alone will be able to correct for R30bn more in salaries and benefits over the MTEF. However, the document also mentions that these measures imply continued restrictions on public sector employment. An example of this would be voluntary early retirement packages. While this seems a

prudent, albeit likely insufficient, way to deal with the wage bill, it is at least somewhat at odds with the framework agreement agreed to by the social partners at the recent Presidential jobs summit. The agreement said that: "Government has reiterated that there will be no retrenchments in the public sector and it has committed to addressing the imperative of filling all critical vacancies in the Public Sector."

In terms of borrowing implications, the higher deficits imply that **government's borrowing requirement**¹ increases from 4.6% of GDP in 2018/19 to 5.2% during 2021/22. Talking specifics, relative to the February Budget outlook, Treasury expects to issue R12bn and R28bn more long-term government bonds in 2019/20 and 2020/21. Assuming a 48 week year, this implies R250 million more issuance per week than assumed in the Budget for 2019/20 and R590 million more during the 2020/21 fiscal year. On net, the increased issuance should be viewed in a negative light by the capital markets.

Expenditure ceiling intact as compensation budget on hold

The MTBPS contains marginal adjustments to the medium-term expenditure framework, mainly reflecting reprioritisation of existing budgets. The main budget **expenditure ceiling** for the current year and the next two years remains unchanged from the 2018 Budget. Adjustments for the 2018/19 fiscal year adds R17.4bn to spending, which includes recapitalisation of South African Airways (R5bn), the South African Post Office (R2.9bn) and South African Airways Express (R1.2bn). Funding is also allocated to drought relief and education infrastructure. These additions are fully offset by the use of the contingency reserve, projected underspending by departments and declared unspent funds. The level of the expenditure ceiling will be maintained for the next two years and is set to expand by 1.5% in real terms in 2021/22. In all, real non-interest spending is projected to grow by 1.9% per year over the MTEF period.

Table 3: Consolidated government expenditure

	Average MTEF growth (nominal %)	
	Budget 2018	MTBPS 2018
Current payments	7.5	7.8
Compensation of employees	7.3	7.2
Transfers	8.4	8.0
Payments for capital assets	7.6	7.1
Total	7.6	7.8

Source: Budget Review 2018, MTBPS 2018

To maintain the expenditure ceiling, and to support policy priorities, the MTBPS reflects **reprioritisation** of current baseline budgets to the tune of R32.4bn over the next three years. Reprioritised resources support the president's economic stimulus and recovery plan, along with some non-discretionary and infrastructure spending pressures. In addition, R14.7bn has been shifted within grants for the upgrading of informal settlements.

¹ This excludes the borrowing of state owned enterprises, which is included in the public sector borrowing requirement.

In all, **total consolidated spending** is expected to post annual average nominal growth of 7.8% over the MTEF period (see [Table 3](#)). The fastest-growing area of spending is **debt-service costs** (10.9% over the MTEF period), reflecting the widening of the budget deficit and projected increases in debt. The largest component of spending remains **compensation of employees**, accounting for 34.7% of the total. Expenditure on compensation is expected to grow at an average of 7.2% per year over the medium term, a marginal downward adjustment relative to the February Budget (see [Table 3](#)).

The MTBPS places significant emphasis on the need to prioritise spending toward capital assets and infrastructure programmes as opposed to current expenditure. Indeed, no adjustments were made to compensation budgets over the MTEF and some additional funds went to infrastructure programmes. This should be seen as only the start of a process that will hopefully gather steam over time. Nominal growth of only 4.1% (i.e. declining in real terms) in **general government infrastructure expenditure** is pencilled in over the MTEF period (see [Table 4](#)). This, combined with the strained balance sheets of state-owned companies, suggests that overall public-sector infrastructure investment is expected to contract in real terms over the medium term.

However, various interventions aimed at increasing the efficiency of existing infrastructure spending have been announced, including those aimed at addressing weaknesses in planning and implementation, and measures to strengthen accountability and transparency. The infrastructure initiative, in the form of an infrastructure fund, announced as part of President Ramaphosa's economic stimulus and recovery plan is in the planning stage, with details deferred to the 2019 Budget. Given budgetary constraints in the public sector, the MTBPS suggests that one of the key focus areas to unlock infrastructure investment is to involve the development finance institutions and the private sector as key financing vehicles. Finally, improved oversight and implementation of existing budgets is expected to sharply reduce underspending, currently estimated at R30bn over the MTEF period. While these are welcome developments, the MTBPS suggests that public sector infrastructure budgets will remain under pressure over the medium term as competing policy priorities continue to crowd out capital spending.

Table 4: General government infrastructure expenditure and estimates

R billion	MTEF estimates				Total
	2018/19	2019/20	2020/21	2021/22	
National	15.3	15.5	15.8	16.6	47.9
Provincial	53.5	54.9	56.9	60.0	171.9
Local	59.7	60.4	63.7	67.1	191.2
Public-private partnerships	5.9	6.1	6.4	6.8	19.3
Public entities	16.2	17.4	18.1	19.1	54.6
Total	150.6	154.3	160.9	169.6	484.9
% change (nominal)		2.4	4.3	5.4	4.1

Source: National Treasury

Macro implications

Over the very short term, at least until the dust settles, the rand exchange rate and government bond yields may be under some pressure in the wake of the MTBPS. More important is how **Moody's** will respond. Although they have not provided a date for when they will pronounce on SA's credit rating, it is likely to be in the next number of weeks. Our initial assessment is that Moody's is likely to adjust the outlook for SA's credit rating from stable to negative in the wake of the fiscal metrics outlined in the MTBPS. We think it is unlikely, although not impossible, that they would go straight from a stable outlook on a rating to an outright downgrade. However, should the February 2019 Budget show a similar (or worse) debt trajectory than outlined in the MTBPS, the agency is likely to join S&P Global and Fitch in moving the rating to sub-investment grade. This will have significant adverse financial market and real economy implications.

In terms of **monetary policy**, our baseline forecast is for a 25bps repo rate hike at the November MPC meeting. The fiscal deterioration outlined in the MTBPS adds to the argument in favour of such a move. On balance, the MTBPS is unlikely to provide any significant boost to **business** and **consumer confidence**. The prudence displayed by Minister Mboweni's speech, including the drive to resurrect key state institutions, and the fact that the MTBPS suggested major tax hikes or spending cuts are unlikely in next year's main Budget will be seen as a positive. However, the underlying weakness of SA's fiscal situation may dilute these more positive takeaways from the MTBPS.

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