03 September 2020

NEDBANK

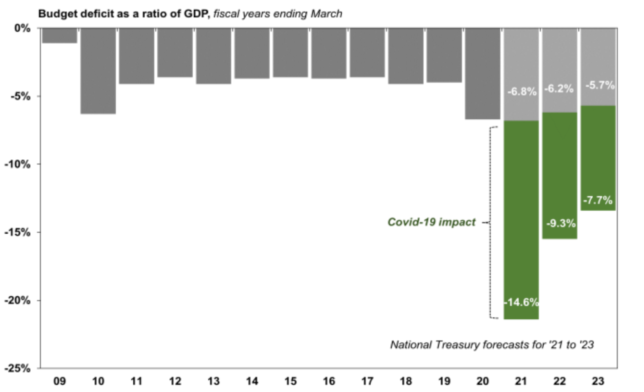
South Africa and the IMF

Economics | South Africa

Is it time for lessons on the loan conditionalities?

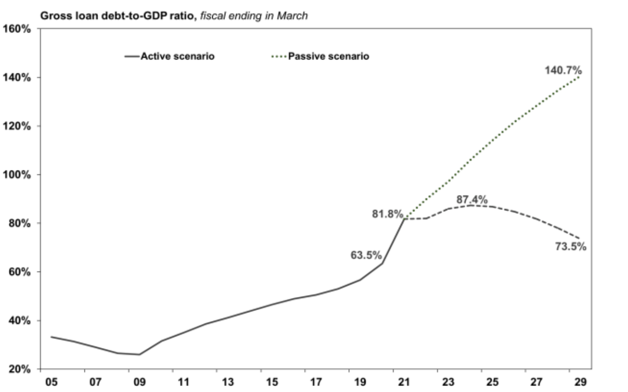
- The government's commitment to policies that will stimulate local economic growth and job creation, thereby helping to stabilise the rapidly deteriorating fiscal position, faces a stern test. The 'Covid-19 loan' has brought to the fore the politically contentious issue of whether the time for National Treasury to turn to the International Monetary Fund (IMF) for budget support – regarded as a distant possibility as recently as February 2020 – has finally dawned. If that is so, is it time for South Africa to be immersed in the conditionalities of IMF fully fledged budget support, and more so the restrictions meted out on those who do not put in the effort to pass the test?
- The IMF's 5-year, US$4.3 billion loan to South Africa was extended under the support programme for countries in need of emergency assistance to ameliorate the economic effects of the Covid-19 pandemic − the multilateral agency's first facility to the country since 1993. South Africa is the first and only economy so far with a well-developed bond market and without an IMF-monitored macroeconomic reform programme in place to tap the emergency facility. Absent are the onerous lending conditions that specify benchmarks for budget deficits and the public sector wage bill, limit social transfers and continuous financial assistance for state-owned enterprises, and prescribe debt thresholds. These are the very tests that South Africa has not passed in recent years, despite the urgency to reduce the budget deficit and contain the rapidly expanding public debt burden. The emergency loan can be rolled over within its maturity period only in cases where the country has undertaken a staff-monitored programme. Therefore, nations in need of further assistance will have to be sign up for fully fledged budget support.
- The economic impact of Covid-19 is severe. National Treasury's 'slow' scenario, under which real GDP plunges by 12.1% in 2020, seems plausible, although our forecast is a lower -8.1%. Government projects the main budget deficit to more than double to 14.6% in 2020/21 compared with the 6.8% estimated in the February 2020 budget, with wider outcomes also expected in 2021/22 and 2022/23 (chart 1). National Treasury predicts that prioritising measures to stabilise and reduce the public debt stock will help to contain the debt-to-GDP ratio to a peak of 87.4% in 2023/24 ('active scenario'), without which the ratio will surge to 140.7% by 2028/29 ('passive scenario') (chart 2).
- Reducing the budget deficit will be necessary to stabilise the public debt stock. Financial assistance to key state-owned enterprises was a key contributor to budget deficits since 2008/09. In 2019/20 bailouts amounted to R59.8 billion and accounted for 18% of the main budget shortfall, and they totalled R187.4 billion between 2000/01 and 2019/20 per National Treasury figures. Eskom absorbed R132.7 billion of the R162 billion bailouts between 2008/09 and 2019/20. The electricity utility, which is not able to service its debt obligations from cash generated from its operations, has reported that its debt stock rose to R488 billion in March 2020 from R440 billion a year earlier, an 11% rise which strongly suggests that Eskom will require bailouts higher than the R122 billion (for the fiscal years 2020/21 to 2022/23) estimated in the February 2020 budget.

Chart 1: Budget deficit to widen significantly…



Source: National Treasury South Africa

Chart 2: …and raise public debt further



Source: National Treasury South Africa

135 Rivonia Road Campus,
135 Rivonia Road, Sandton, 2196, South Africa

http://nedbankgroup.co.za

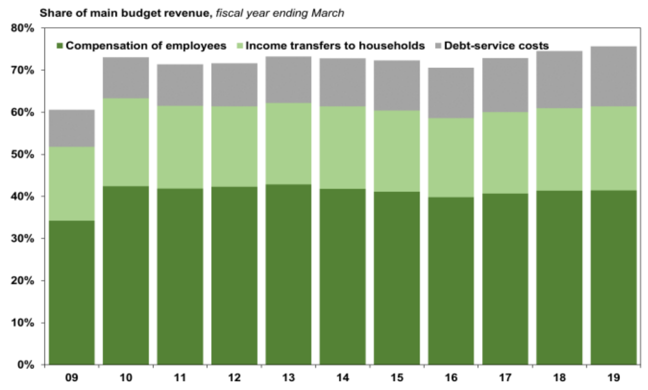
Group Economic Unit

Isaac Matshego
+27 10 234 8358
IsaacMat@nedbank.co.za

Nicky Weimar
+27 10 234 5547
NickyWe@nedbank.co.za

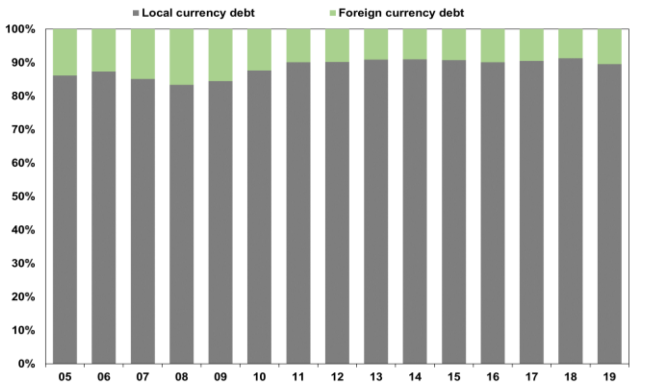
- It is our contention that fiscal reform will be formidable but not unattainable. Consolidating public spending towards a more efficient, growth-enhancing stance will be a fundamental test as recurrent commitments account for the bulk of total expenditure. The public sector wage bill, social transfers and debt service costs have taken up more than 70% of main budget revenue over the past decade (chart 3). The figure will exceed 95% in 2020/21 as the revenue plunge will push the wage bill to 52% of budget revenue, while higher transfers to households will also contribute. This proportion excludes the planned reduction of the national wage bill by a net R600 million, which, if achieved, will have only a negligible effect on the R567 billion consolidated wage bill. The high proportion of recurrent expenditure commitments thus makes the shift to meeting some expenditure goals only through available revenue ('zero-based budgeting') an arduous task.
- Boosting economic growth will be equally paramount. Poor growth is eroding the fiscal revenue base. Corporate profits are subdued and job losses are mounting. Private sector fixed-investment spending has contracted since 2016 and will remain weak for as long as low growth expectations persist. Reviving business confidence by eliminating policy uncertainty and improving the efficacy of public spending will help to raise the fixed investment-to-GDP ratio to 30% over the next decade – a National Development Plan goal – and would go a long way in shifting growth towards a more inclusive, job-creating pattern.
- Failure to consolidate public expenditure and boost economic growth will tighten the space for financing the budget deficit via local currency bonds, the traditional source of deficit financing in South Africa (chart 4). Foreign bondholders have reduced their exposure to government bonds significantly (chart 5), a situation that compelled the South African Reserve Bank to accumulate government bonds totalling R30.2 billion since March as secondary-bond-market buyers were simply absent. The precarious fiscal situation points to foreign portfolio investors not returning to South African shores speedily. Additionally, external rating downgrades deeper into sub-investment grade are highly likely (chart 6). Even if National Treasury's budget deficit estimates and debt 'active scenario' are achieved, South Africa's ratios will remain well above the medians of BB-rated sovereigns, calculated by Fitch Ratings at 6.8% and 46.5% respectively. A confluence of these pressures will narrow the base of bond buyers and raise the cost of funding for the sovereign even further.
- The economic situation magnifies the need to stabilise public finances and boost economic growth. Financing the wider budget deficit will prove to be a difficult test. A key benefit could be the abundance of global liquidity, which has in the past been a boon for financing of the domestic budget shortfall. This time, however, a poor growth outlook, weaker government finances and a higher risk premium suggest that South Africa will struggle to finance the deficit predominantly via local-currency bond issuance. All the effort therefore must be focused on containing the growth of public expenditure and raising aggregate economic growth.
- Achieving a primary surplus by 2023/24, from a primary deficit of 9.7% in 2020/21 projected by National Treasury, will require significant adjustments to the non-interest expenditure budget. If revenue growth averages 11% per annum over 2021/22 to 2023/24, spending cuts averaging at least 0.7% of GDP per annum will be required to meet the target, which more than doubles to 1.7% of GDP per year if annual revenue growth averages only 5%.
- Government's resolve to restrict growth in the public sector wage bill and income transfers will be tested ahead of the 2021 local government elections and the 2024 national poll. Given limited appetite among foreign portfolio investors for local currencies bonds, failure to reduce spending will leave government with only two funding options: Increase issuance of foreign currency bonds, which carries interest-rate and currency-mismatch risks, or request a fully fledged concessional multilateral facility. If the political noise around the Covid-19 loan is anything to go by, political resistance to secure a formal IMF facility will be fierce. However, in the event of high foreign-currency borrowing costs, the South African government will be faced with limited choices. It is therefore increasingly clear that it is time for South Africa to familiarise itself with the corridors of the Washington institutions. Political resistance will only delay what is likely to be an inevitable fate.

Chart 3: Recurrent expenditure commitments absorb a large proportion of revenue



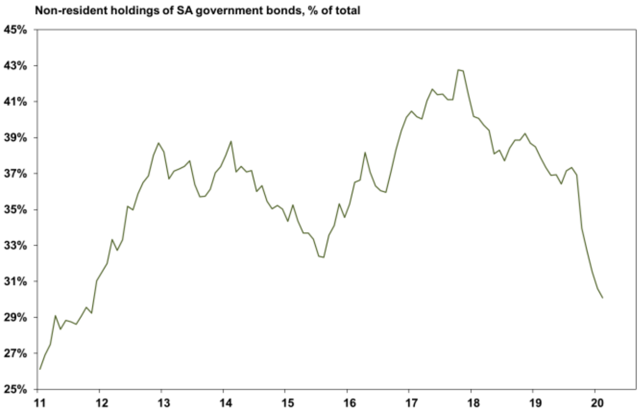
Source: National Treasury South Africa

Chart 4: The debt stock is dominated by local currency bonds



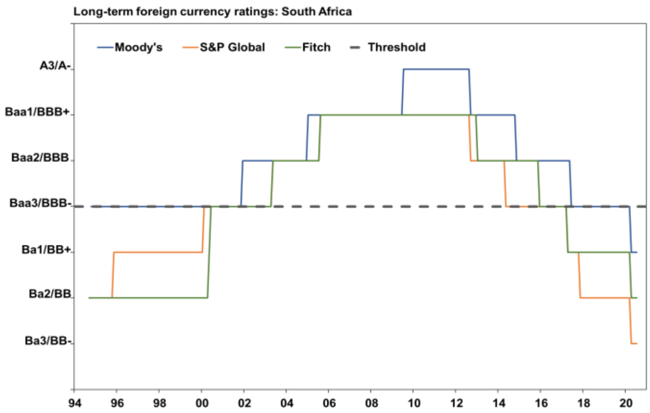
Source: National Treasury South Africa

Chart 5: Foreign bondholders selling SA bonds…



Source: National Treasury South Africa

Chart 6: …and further rating downgrades are likely



Sources: Fitch Connect, Moody's Investor Services, S&P Global Ratings

Disclaimer