SA needs a hardcore Budget

A strong Budget will come down to simple action and hard choices taken now for the long-term benefit of the country. The main thing to look at, given that the Moody's is watching closely, is the need to rein in the budget deficit, which is starting to spiral even more out of control.

Mike van der Westhuizen, portfolio manager, Citadel

In the 2019 Medium Term Budget Policy Statement (MTBPS) the Treasury projected a consolidated Budget deficit of 5.9% of GDP, averaging 6.2% of GDP over the next three years.

A low growth, low inflation environment also affects the debt-to-GDP trajectory, the sustainability of which Finance Minister Tito Mboweni has already warned about. As a proportion of South Africa's GDP, the MTBPS notes a hike in gross debt from 56.7% in 2018-19, to 60.8% in 2020-2021 and 71.3% in 2022-23 if the status quo does not change, something the rating agencies are understandably concerned about.

These numbers show that the previous goal of fiscal consolidation is currently not on target. Although it must be said that while Treasury appears to be doing everything in its power to stop the slow bleed, it's a cooperation issue with the rest of government and other influential stakeholders.

This disconnect between what needs to happen and the disinclination within government to act is likely to come through when Mboweni's National Budget is revealed later this month.

Revenue under pressure

Distilling the multiple issues at play, government needs to find about R150bn in savings over the medium-term expenditure framework, being the next three years. So that's essentially R50bn a year in savings that needs to come through.

But how can this be achieved?

Treasury could look, once again, to the taxpayer. But, with the taxpayer already squeezed, options are increasingly limited. In prior years, we've seen personal income tax hikes and last year a VAT hike. Easy wins are fuel levies and sin taxes that rise every year, as well as bracket creep, i.e. not adjusting the tax brackets for inflation. Other potential tax avenues could include a new upper tax bracket, wealth tax, estate duties or even changes to capital gains tax or dividend tax. Although helpful, these don't really do the heavy lifting.

There has been talk that the only really effective lever left to pull could be to raise VAT by one percentage point to 16%, which would inject between R20bn and R35bn in revenue. Although it would be a particularly unpopular move politically, it is increasingly possible.

Expenditure in the crosshairs

Given the revenue constraints, I believe that all the hard work should be done on the expenditure side. But, again, taking steps to contain and curb expenditure will come down to political will.

The big line items here are public sector wages (about 34% of expenditure), debt service costs (10%) and social grants (10%). Interest payments and social grants are essentially fixed, leaving the wage bill as the main lever. This is a bit tricky at this stage since multi-year wage negotiations are still in process and will only conclude around March 2021, so we will watch this carefully.

The government tried a voluntary resignation and natural attrition approach to reduce the wage bill, but that hasn't been effective. Maybe the lower inflation outlook from the Reserve Bank and pinning of inflation expectations might help in negotiating lower wage hikes, but that is unlikely to be enough.

Even if government took a firm stance of CPI less 2%, which would have the trade unions baying at its feet, it would only save about R105bn over three years, leaving us some R45bn short. The point is that even a drastic decline in wage growth doesn't result in sufficient scaling back in spending.

The SOE drag continues

Despite this constrained picture, there is still bound to be more budgetary support doled out for state-owned enterprises (SOEs) and this issue will loom large over Mboweni's speech.

In late-January we saw the Development Bank of South Africa (DBSA) grant a loan to South African Airways (SAA) as part of its restructuring. That represents a red flag in terms of the cross contamination of SOEs, with a well-performing SOE such as the DBSA bailing out a poor-performing one. Government cannot afford to use its balance sheet to rescue these SOEs, so it is rearranging the deck chairs. Our concern is the strain this might put on the better-performing SOEs. For now it might not be a big issue given that the DBSA does have rules governing its lending, but the trend isn't pleasing.

And Eskom is likely to remain both a concern and a drain. Clearly there is much in-fighting at the parastatal and disagreement about its turnaround direction coupled with bouts of load shedding, which indicates that South Africa is certainly not out of the woods. Eskom will, again, be a massive issue to watch for in the Budget. For at least the next few years, support will have to be pencilled in for the utility. If that number were to rise significantly or if there were further talk of taking Eskom debt on the government balance sheet, then we would be in deep trouble.

What could prove a fillip for the country would be positive developments around key issues such as power generation. There has been much talk about mining companies, and other businesses, being permitted to generate their own electricity and for independent power producers to come onto the gird, but we are yet to see formal communication in this regard. If something concrete is announced, even some compromise around public-private partnerships, then that would be very positive.

The D-Day downgrade

While the state fiddles, and the economy burns, a downgrade in the country's sovereign credit rating continues to hang over South Africa's head. While the markets have long priced this in, the continued expectation that the axe will fall is, in itself, creating uncertainty and tension.

On 28 January 2020 Moody's Investors Service analysts noted that it was "a bit early" to judge the impact of both policy and structural reforms. Lucie Villa, Moody's lead sovereign analyst for South Africa, told Bloomberg that while the data was not pointing to either a particularly positive or negative direction, that "there is nothing really to flag for the time being". This indicates that Moody's may well be prepared to give SA more leeway, but obviously, the credit rating agency will be keeping a close eye on Mboweni's Budget.

Certainly, everyone expects this Budget to be poor, but they might manage to demonstrate the will to cut expenditure and show just enough fiscal consolidation and, in that case, Moody's might delay any decision until November, after the next MTBPS.

That said, while government might do enough to keep Moody's at bay for the first half of this year, it remains our view that the agency will downgrade South Africa in 2020. While this would put South Africa out of the World Government Bond Index, I believe it is time for the country to take its medicine. Foreigners would come in and sell some of our bonds on index exclusion but, with some of the most attractive yields available, there would definitely be buyers stepping in.

Reading the mood

Anyone who follows Mboweni on Twitter will be keenly aware that the finance minister is getting significant pushback, making him increasingly despondent with the lack of progress. There appears to be considerable opposition to his plans, as laid out in the economic strategy document released in August 2019.

At this juncture, even those plans might not be sufficient. There is no use putting a plaster on a bullet wound. Treasury knows what needs to be done, but the rest of government needs to come on board, stop the wrangling, and make some tough decisions to turn the country around. Until they do, the economy will remain locked in a vicious circle of low growth.

Without cooperation within government and putting fiscal consolidation on the right path we can't generate growth, which puts us into this death spiral. Structural economic policy implementation and talk around that would be positive in the Budget. We've had all these plans, which are brilliant on paper, but government still lags on implementation.

ABOUT THE AUTHOR

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