FINANCING OF THE MAIN GOVERNMENT BUDGET DEFICIT

ERSA : Fiscal Futures: Part 2 – "Financing the budget in the post-corona world”
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Financing of the gross borrowing requirement (main budget deficit plus redemptions)

R billion	2019/20 Preliminary	2020/21 Budget	2020/21 Revised	2021/22 Medium-term estimates	2022/23 Medium-term estimates
Gross borrowing					
Main budget balance	**-345.3**	**-368.0**	**-709.7**	**-495.6**	**-430.5**
Redemptions	**-70.7**	**-64.7**	**-67.2**	**-64.9**	**-150.0**
Domestic long-term loans	-19.4	-52.5	-52.5	-60.5	-134.2
Foreign loans	-51.2	-12.2	-14.7	-4.4	-15.8
Total	**-416.0**	**-432.7**	**-776.9**	**-560.5**	**-580.5**
Financing					
Domestic short-term loans (net)	36.1	48.0	146.0	56.0	64.0
Domestic long-term loans	305.4	337.7	462.5	388.4	451.4
Foreign loans	76.1	29.3	125.2	31.9	63.2
Change in cash and other balances [1]	-1.6	17.7	43.2	84.2	1.9
Total	**416.0**	**432.7**	**776.9**	**560.5**	**580.5**

1. A positive value indicates that cash is used to finance part of the borrowing requirement

Source: National Treasury

- Since February 2020, the gross borrowing requirement for 2020/21 has increased by R344.2 billion to R776.9 billion. Government has revised its financing strategy to minimise the effect of this deteriorating financial position on its stock of debt and on debt-service costs
- The domestic capital market is under pressure. To moderate its domestic borrowing, government will draw down sterilisation deposits. It will also source funding from international finance institutions
- Existing foreign cash deposits will be used to finance foreign currency commitments. The proceeds from international loans will be converted into rands to partially finance domestic commitments

Government funding options are not that many to sustain the level of gross borrowing (1)

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Market Funding (Predominant financing)

- Weekly Treasury bill issuance increased by R5.0 billion since 27 March 2020 from R7.9 billion R12.9 billion on 12 June 2020.

Instrument	Weekly amounts -MTBPS	Weekly amounts – 2020 Sup Budget
Treasury bills	7.9	12.9
Fixed-rate - competitive bonds	4.65	6.6
Fixed-rate - non-competitive bonds	0.45	2.0
Inflation-linked bonds	1.04	2.0
Total (R bn)	**14.04**	**23.5**

Risks to the market funding and borrowing costs

- Further market uncertainty, volatility and lack of trading and funding liquidity
- Increase in issuance and further downgrades will add to elevated cost of borrowing

Government funding options are not that many to sustain the level of gross borrowing (2)

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MDB Budget Support Funding (small portion of non-markatable debt)

- Exploring US$ 7 billion (R125 billion) funding from IFIs
- The funding costs are favourable relative to the market funding pricing
- South Africa is competing for funding with other countries
- Funding specific for COVID-19 and further funding cannot be expected indefinitely

Other sources of funding

- Islamic bonds, Green bonds, Social impact bonds
  - A bond is a bond and is a bond
  - Niche market
  - Small volumes
  - Shorter maturities
  - Complex compliance and reporting
  - Not particularly cheap relative to conventional securities
- Project funding
  - Not perfect fit for SA Budgeting Framework
  - All monies flow into the National Revenue Fund
  - No ring fencing of monies or project
  - With focus on infrastructure, this type funding might come in handy especially with funder oversight and technical assistance

The funding strategy is underpinned by risk guidelines

Description	Benchmark range or limit	2019/20	2020/21
		Estimates	
Treasury bills as % of domestic debt1	15	11,8	12,0
Long-term debt maturing in 5 years as % of bonds	25	11,3	14,6
Inflation-linked bonds as % of domestic debt	20-25	22,9	23,3
Foreign debt as % of total debt	15	10,1	9,5
Weighted term-to-maturity of fixed-rate bonds and Treasury bills (years)	10-14	12,8	11,8
Weighted term-to-maturity of inflation-linked bonds (years)	14-17	13,8	12,6
Other indicators (weighted average)			
Term-to-maturity of total debt (years)		13,0	11,8
Term-to-maturity of foreign debt (years)		13,1	11,5

1. Excludes borrowing from the Corporation for Public Deposits and retail savings bonds

Source: National Treasury

Deterioration in SA credit rating downgrades have negatively impacted SA credit quality and therefore the cost of borrowing

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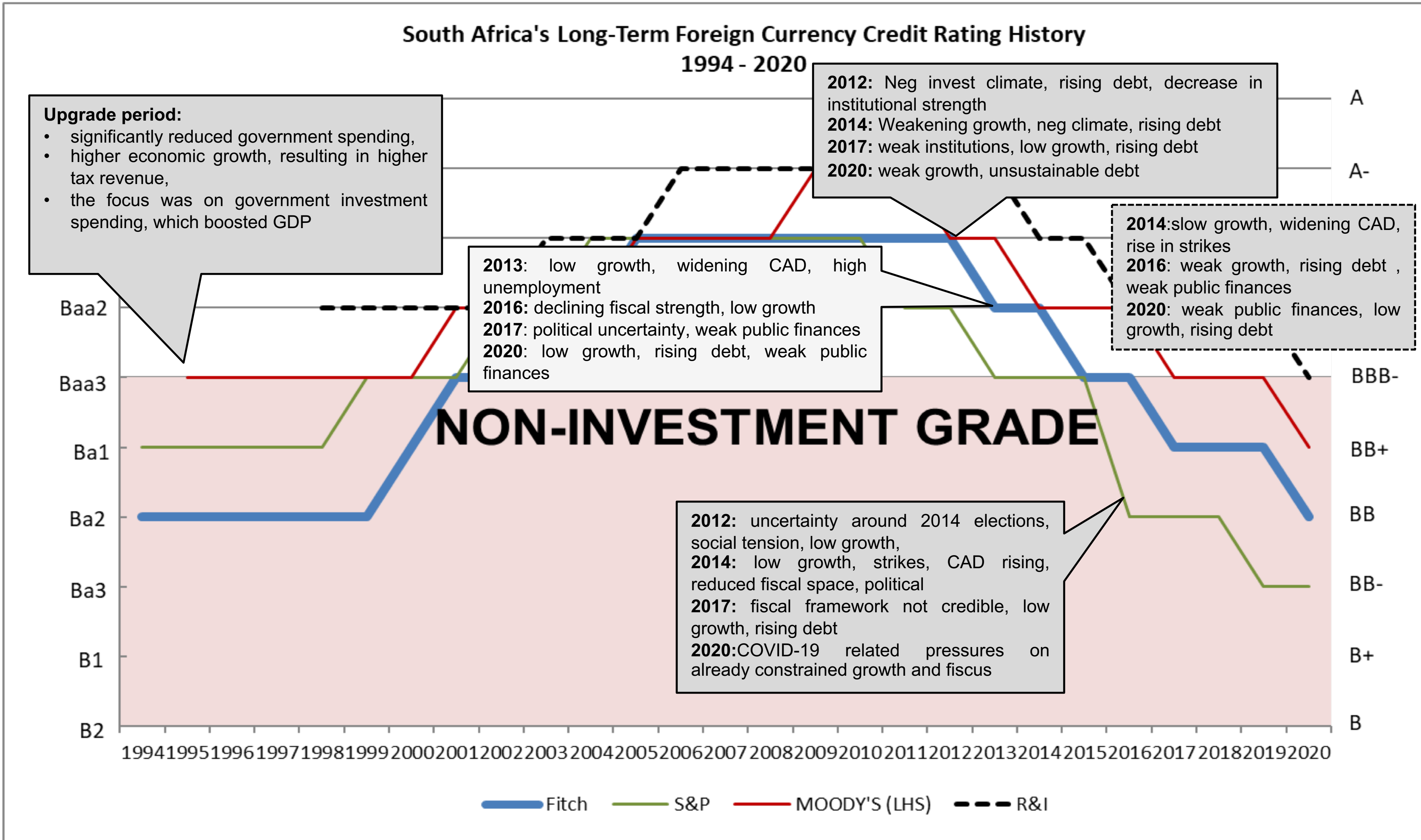
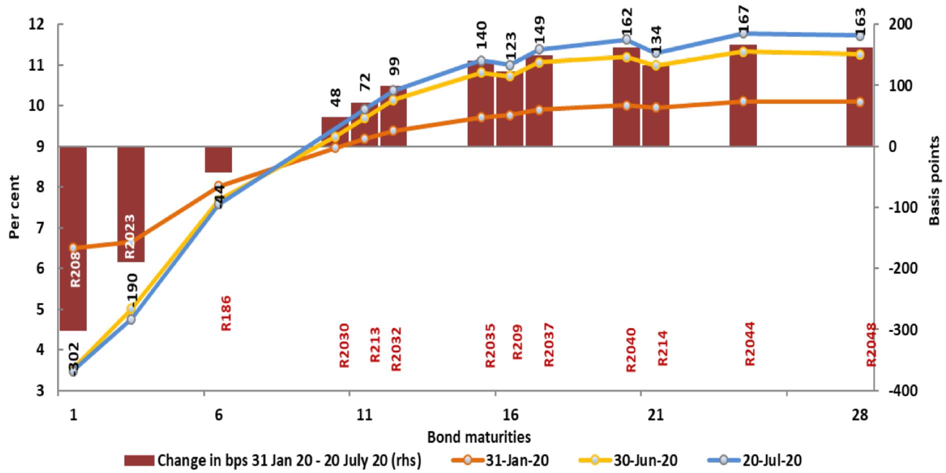
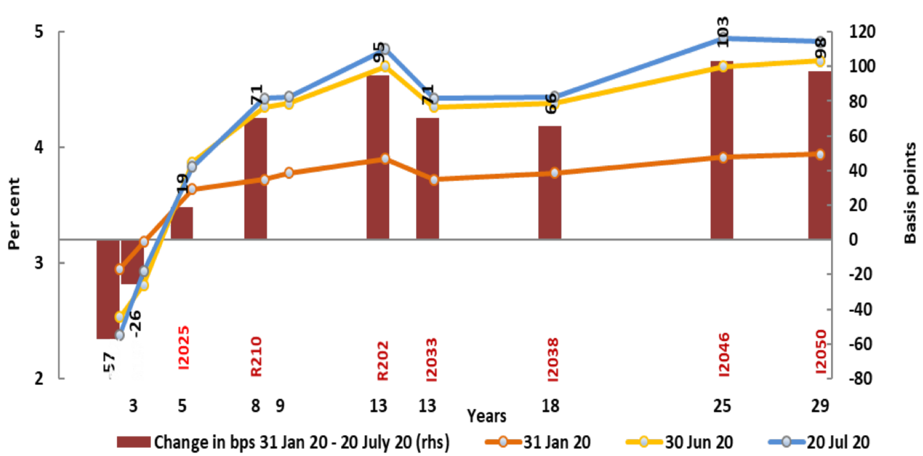


Local currency bonds funding costs have increased significantly, with the increase pronounced in the long end

Fixed rate bond yields – Jan to July 2020



Inflation-linked bonds yields – Jan to July 2020



- Government costs have increased significantly
- Since the January 2020 the yield curve has weakened by an average of 55 bps.
    - The long-end weakened by an 125 bps.
    - The short-end strengthened by an average 178 bps.
    - Fixed-rate bond prices are on average at a 25 per cent discount
    - i.e. government gets 75 cents for every R1 debt issued.
- Inflation-linked bond yields are on average 49 bps weaker since January 2020.
    - Short-dated inflation-linked bonds strengthened.
- Bond auctions remain well subscribed with issuance concentrated on short-dated bonds
- Issuing short-dated bonds while it helped to manage the cost of borrowing it introduced significant refinancing risk and it is not sustainable.
- The bond switch programme which have generally been used to manage refinancing risk have become very expensive and hard to execute

Foreign currency bonds funding costs have increased and recovering slowly to pre-COVID 19 crisis levels

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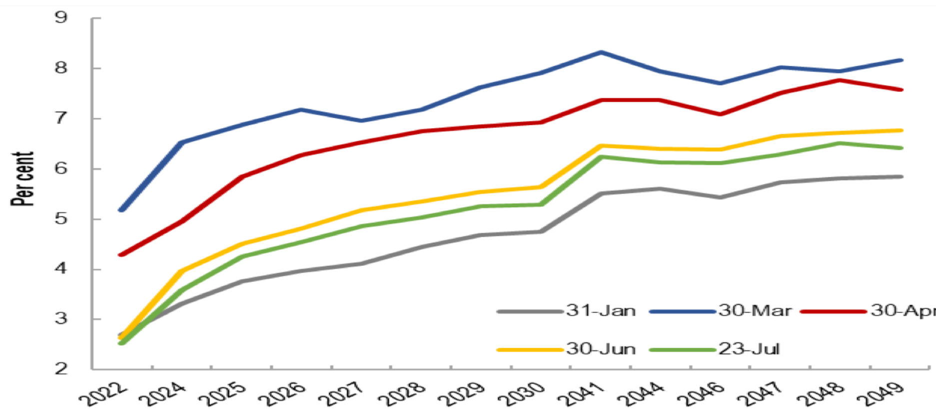
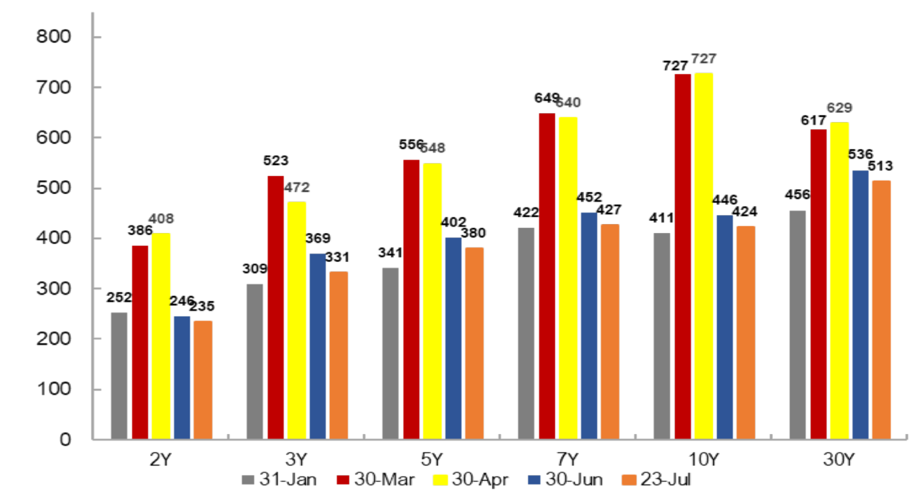
Government US$ bond yield curve



South African foreign bond – US Treasuries spreads



- The US$ yield curve (SOAF) is on average 52 basis points weaker than January 2020.
  - The SOAF curve has rallied by an average 218 basis points across the curve since highs of March 2020.
  - Compared to the weakening of 328 from 31 January to 30 March 2020.
- The SOAF vs US Treasury average spreads have declined from high of 676 bps in March 2020 to the current 385 bps
  - This is due to strengthening of the SAOF curve at a higher pace than strengthening of the US Treasury curve.

Debt-service costs (DSC) continue to increase significantly crowding out other government expenditure

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National government debt-service costs

	2019/20	2020/21		2021/22	2022/23
R million	**Outcome**	**Budget**	**Revised**	**Medium-term estimates**	
Domestic loans	187 276	211 144	215 361	242 767	277 648
Short-term	32 096	25 441	22 566	19 527	24 259
Long-term	155 180	185 703	192 795	223 240	253 389
Foreign loans	17 493	18 126	21 083	20 364	23 425
Total	**204 769**	**229 270**	**236 444**	**263 131**	**301 073**
As percentage of:					
GDP	*4.0%*	*4.2%*	*4.9%*	*4.9%*	*5.4%*
Expenditure	*12.1%*	*13.0%*	*13.1%*	*14.9%*	*16.6%*
Revenue	*15.2%*	*16.4%*	*21.5%*	*20.7%*	*21.8%*

Source: National Treasury

- DSC are the fastest growing expenditure line
- For every R1 of revenue, R0.21 is expected to be spend on servicing debt in 2020/21
- Drivers of the DSC:
  - Quantum of debt
  - Inflation
  - Rand/US dollar exchange rate
  - Interest rates

Significant amount of the main budget revenue consumed by debt-service costs

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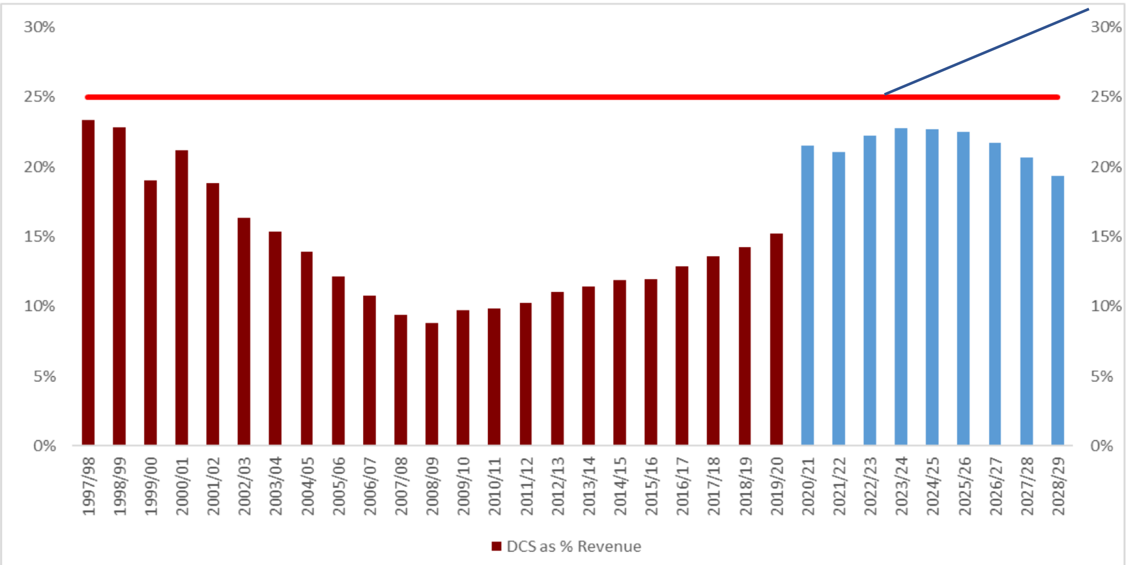
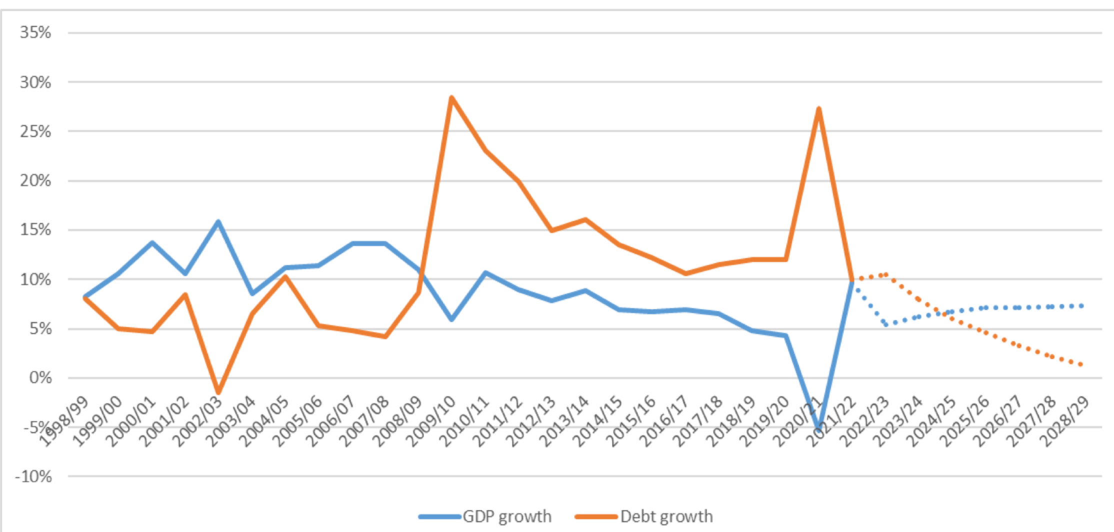




Perceived probability of default is high.

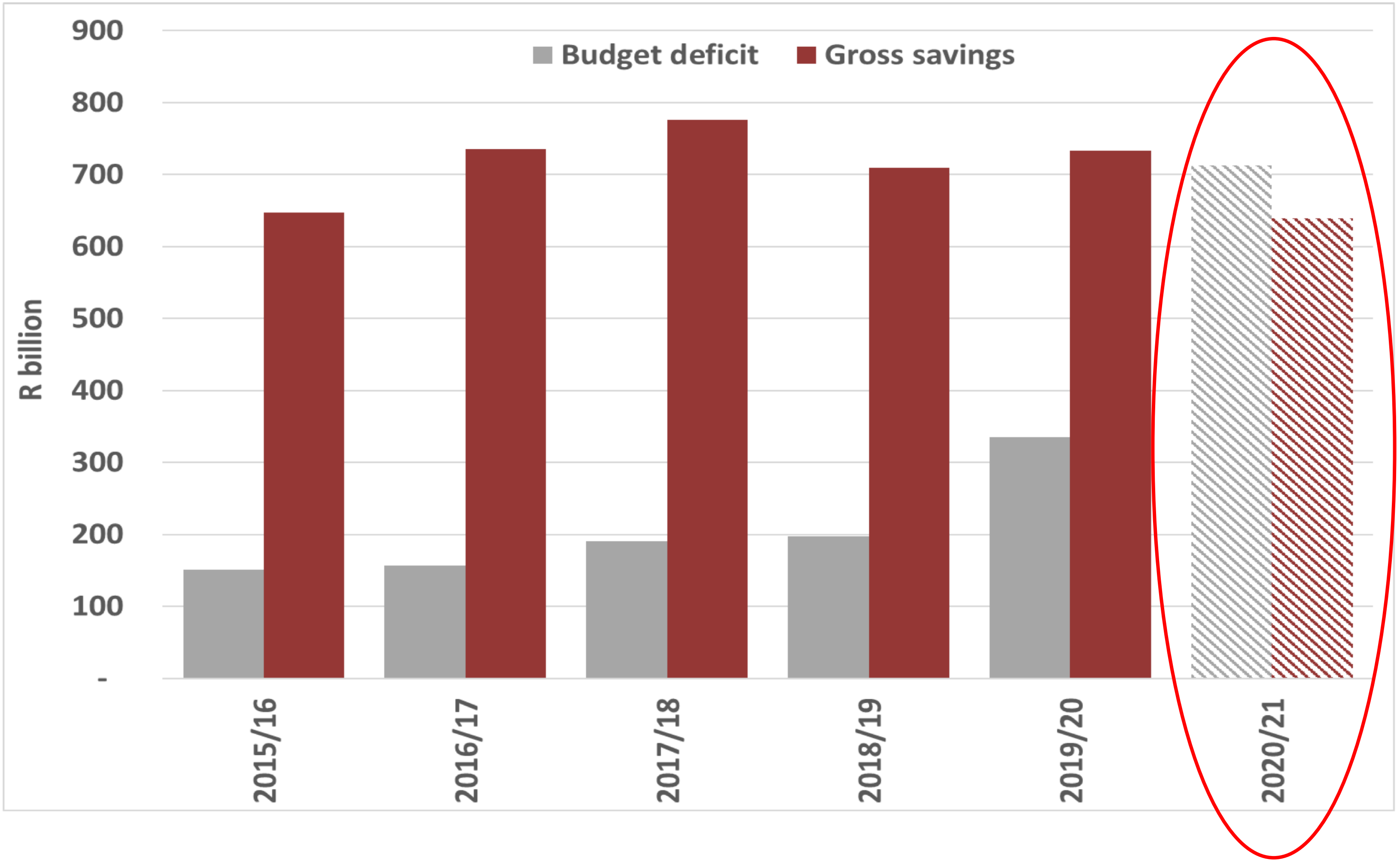
With much of the revenue being consumed by debt service cost the perceived probability of default is higher and would push the cost funding even higher.

Possible monetary intervention to prevent a sovereign default when debt service cost to revenue is high have been know to have inflationary outcome and negative economic consequences.

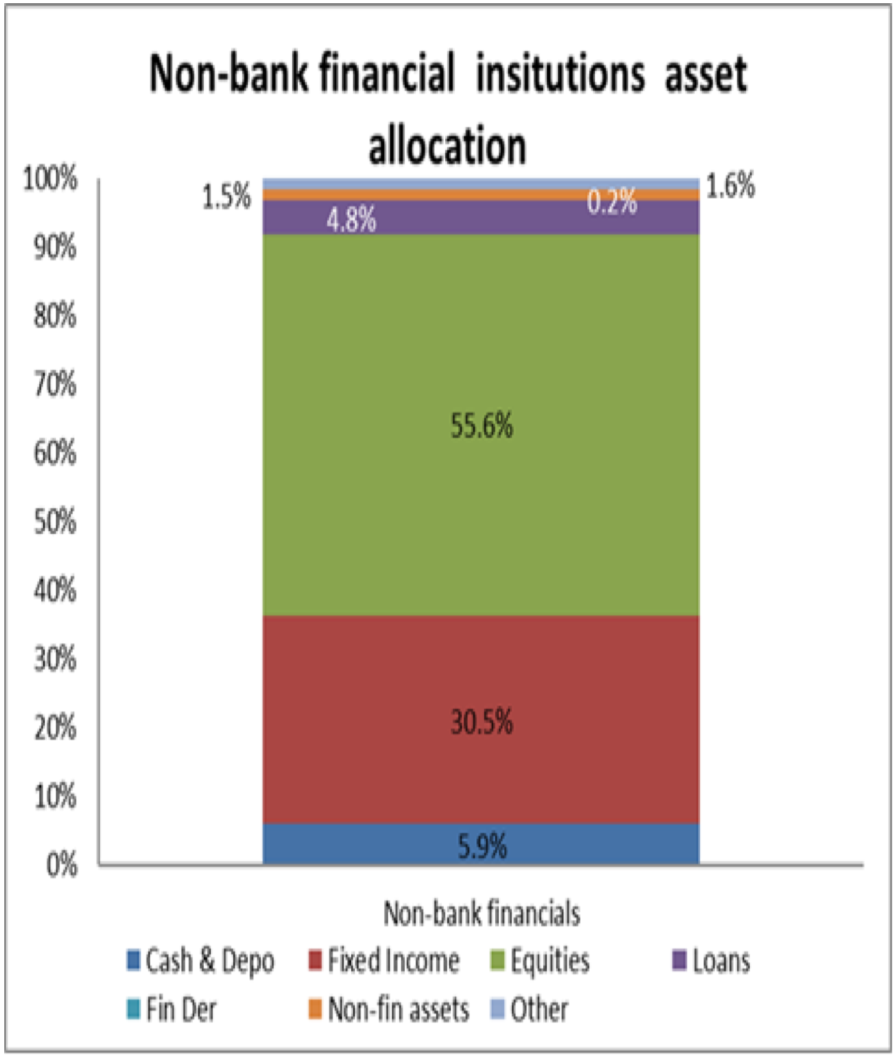
To have a noticeable impact on managing the debt stock the primary surplus needs to cover a substantial portion of the debt service cost.

Growth in debt has been constantly outstripping the growth in the economy.

The budget deficit in 2020/21 exceeds the size of gross domestic savings



Assets under management (Aum) in SA not growing as fast as the government gross borrowing requirement



- Assets under management in South African R15.5 trillion.
  - R9.7 trillion with non-bank financial sector.
  - R5.8 trillion with the banking sector.
- Non-bank financial sector includes: long-term insurers, short-term insurers, official and private pension funds, finance companies.
- Equities make up about 55 per cent of the portfolio, followed by Fixed Income at 30 per cent and third being Cash at 6 per cent.
- While AuM is significant, the funds are already invested and there are limits to various instruments.
- New money per annum that is likely to be deployed to fixed income is likely to be smaller than what government requires.
- Withdrawals from provident and pension funds expected.
- New money is not sufficient to cover increasing government borrowing requirements.

Non-residence holdings of SA government bonds (SAGBs) continues to decline reducing external savings

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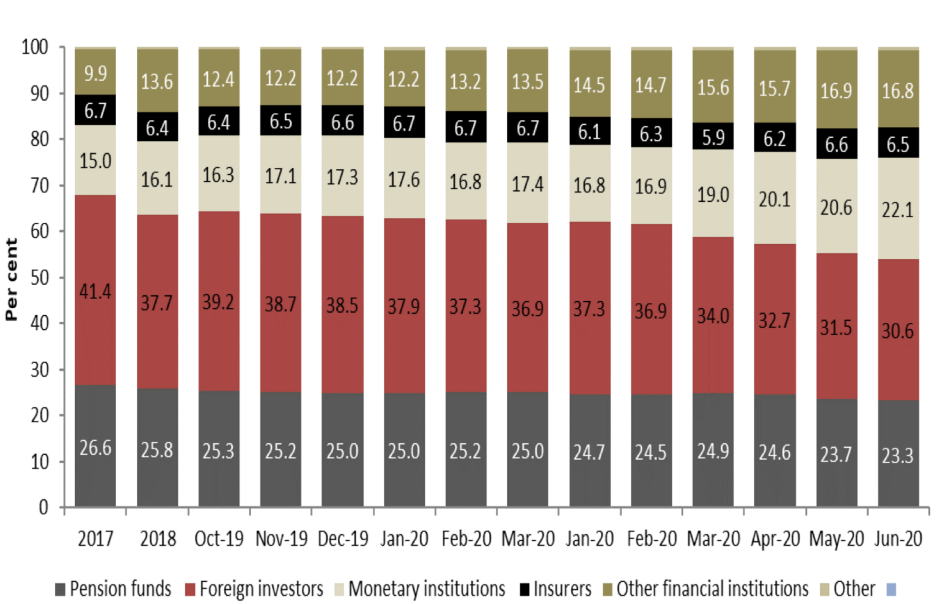
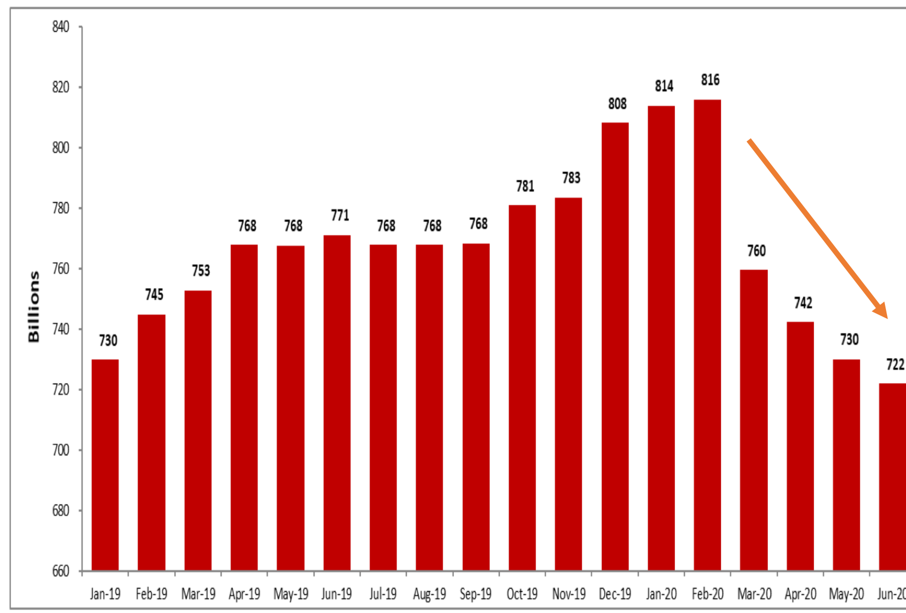
- Foreign holdings of domestic government bonds fell to 30.6 per cent from 31.5 per cent in May 2020.
  - Nominal holdings decreased by R8 billion, from R730 billion as at end of May 2020 to R722 billion by June 2020.
- The uncertainty regarding global economic growth prospects in 2020 sparked capital markets volatility and outflows from emerging markets. SA government bonds yield weakening was exacerbated credit rating downgrade and the exclusion of SA from the Citi World Government Bond Index (WGBI).
- Given the large outflows in the past two months, the risk of further outflows is outweighed by the risk of no new take-up of new supply. This poses a serious challenge given the large increase in government bond issuance in the coming months

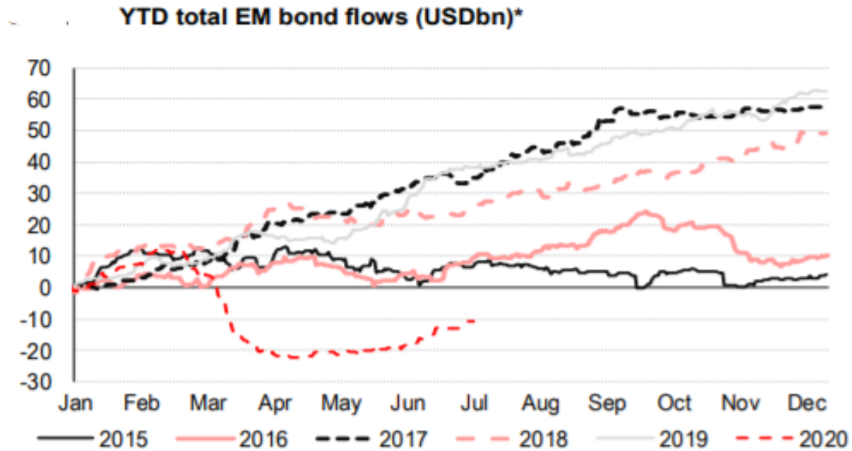
Holdings of domestic government bonds (%), 2017 – June 2020



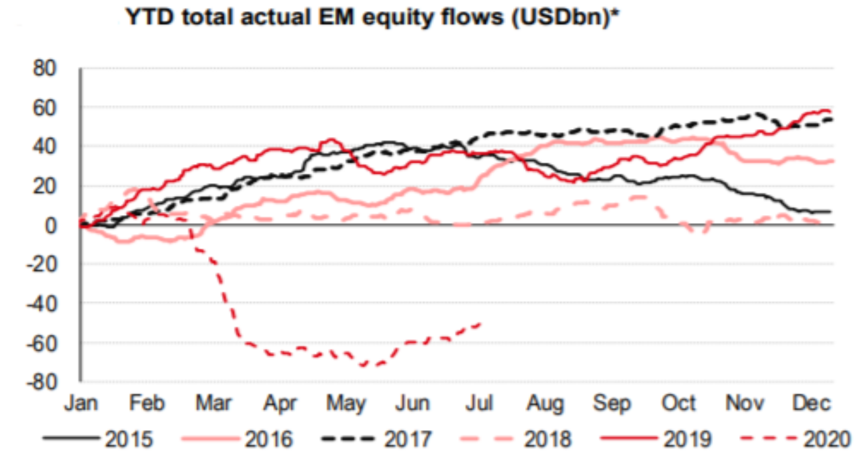
Non-residents domestic government bond holdings, 2019 -June 2020



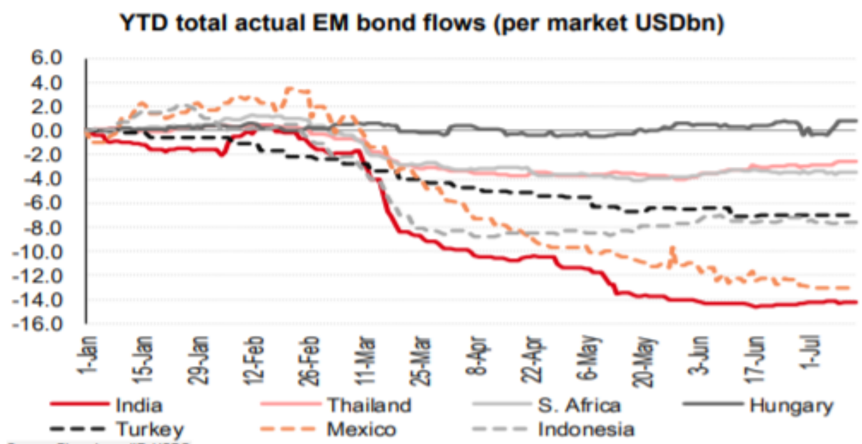
Total Emerging Market (EMs) financial flows on the decline, some EMs impact would be more pronounced depending on idiosyncratic factors



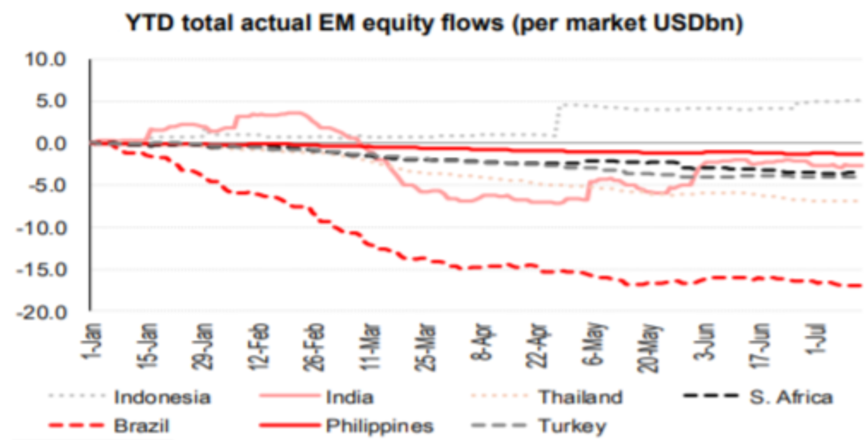
Source: IIF, Bloomberg, HSBC
Note: * Nine markets (Indonesia, India, Thailand, S. Africa, Hungary, Turkey, Mexico, S. Korea and Ukraine) S. Korea and Ukraine data available from 2018



Source: IIF, Bloomberg, HSBC
Note: * Twelve markets (Indonesia, India, S. Korea, Thailand, S. Africa, Brazil, Philippines, Vietnam, Malaysia, Taiwan, Mainland China and Turkey). Vietnam, Malaysia, Taiwan, Mainland China data available from 2014.



Source: Bloomberg, IIF, HSBC
Note: * Seven markets (India, Thailand, S. Africa, Hungary, Turkey, Mexico and S Korea)



Source: Bloomberg, HSBC
Note: * Eight markets (Indonesia, India, Thailand, S. Africa, Brazil, Philippines, Turkey and Malaysia)

SA budget deficit/public debt metrics relative to peers....a concerning picture

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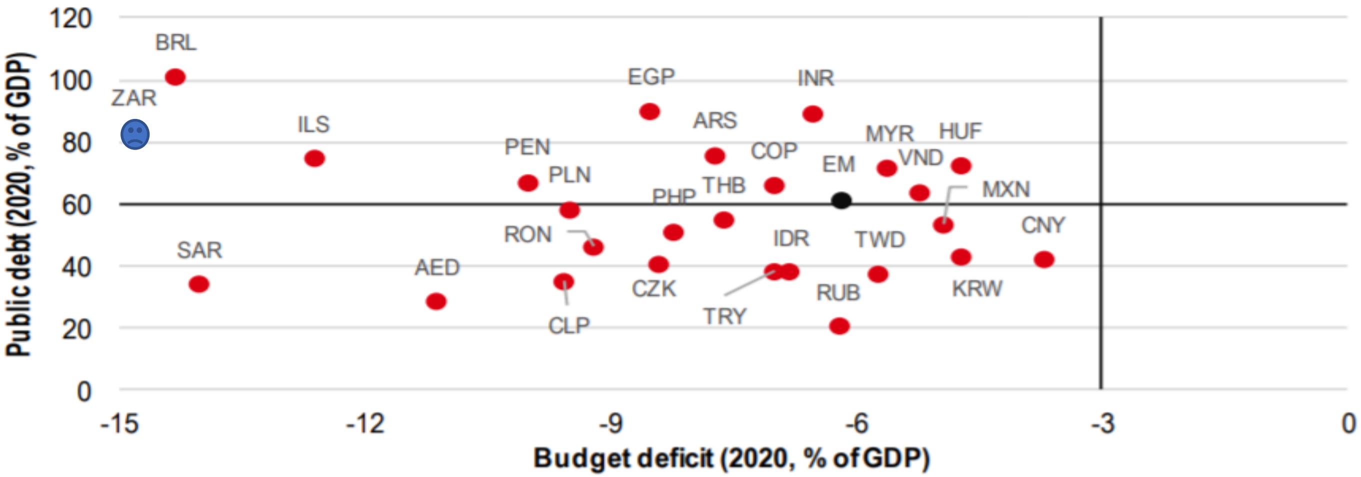

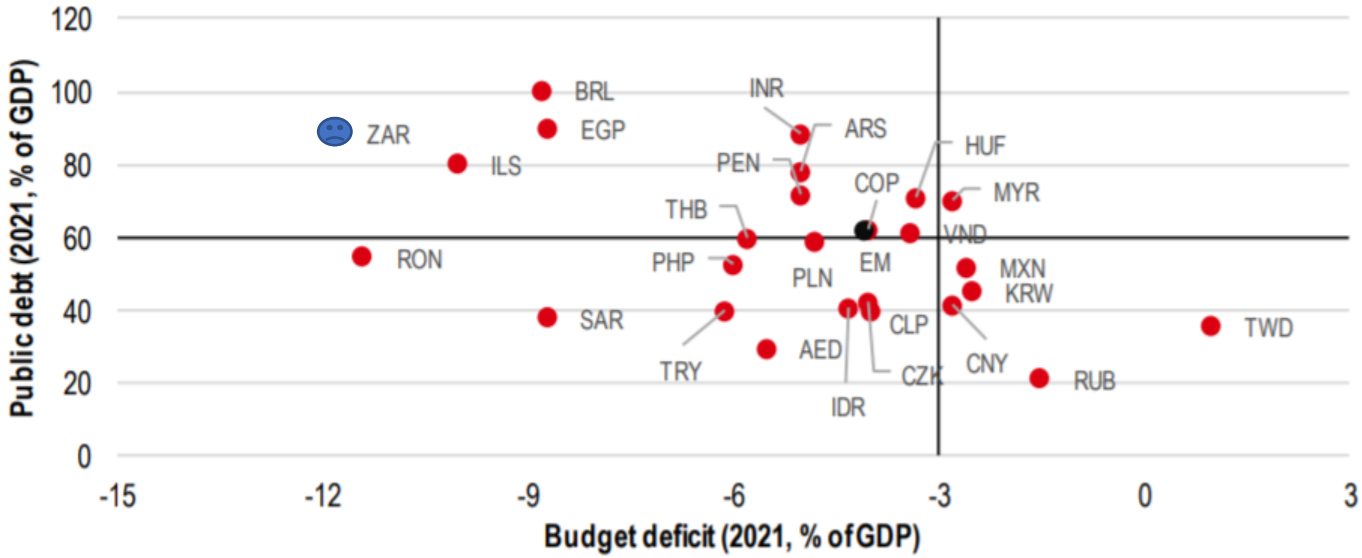

Why SA government can't keep increasing its borrowing without safeguarding its ability to repay?

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- The gross saving rate of SA at approximately 14.5 per cent is low and cannot sustain the level of spending/ investment
- The growth rate of gross borrowing requirement outstrips the growth rate of assets under management(constrained by the level of savings in the country)
- International investors have sold off a significant amount of South African government debt thereby reducing external savings
- The growth in national government debt is crowding out private investment which could result in new job creation and increased revenue
- Growth in debt has been constantly outstripping the growth in the economy
- Rising public debt means that an ever-increasing share of tax revenue is transferred to bondholders
- Debt-service costs are also crowding out service delivery resulting in less money available to spend on for instance health and education
- Government is not generating enough revenue to repay accumulated debt. More borrowing is done to repay debt and interest creating a vicious cycle that could lead to a sovereign debt crisis

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