SA Medium Term Budget: November 2021

Details:

Budget Discussion and release of Report: 1200GMT/1300CEST/0800ET, Thursday 11 November.

MNI Point of View

POV: Tax Windfall Buoys Fiscal Outlook, Markets Eye Grants Policy

This week, Finance minister Godongwana will produce his maiden MTBPS against a far rosier fiscal backdrop than in recent meetings, but don't let that fool you into thinking the purse strings will be any looser. Aided by windfall profits in the mining sector on the back of a commodity super cycle, the Treasury is set to see some reprieve after years of deteriorating fiscal metrics - providing the new Finmin with a more robust platform to (hopefully), in his own words, "not let this opportunity go to waste."

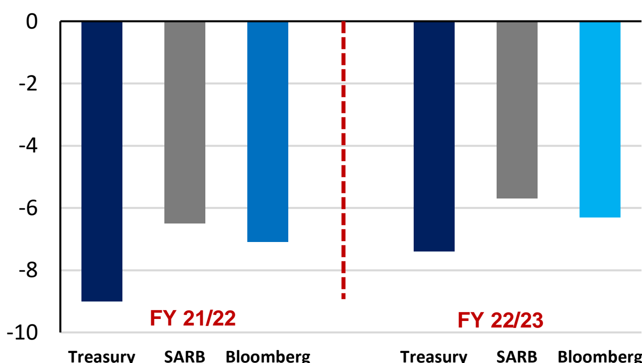
Godongwana will report back on progress made on the Feb 2021 objectives, while guiding towards the next set of changes that will inform the updated budget framework in 2022. The market's focus will likely be on discussion surrounding the feasibility of a basic income/targeted jobseekers grant, potential growth-inducing reforms, slightly narrower issuance targets, public sector wage frugality, limited SOE bailout packages and discussion of Eskom just transition & debt management strategies.

Overall, markets anticipate the budget to be a well-balanced affair under Godongwana, who has thus far followed a similar trajectory to his predecessor Mboweni. Since taking office, Godongwana has kept a firm hand on the fiscal reins, showing limited appetite for unaffordable populist expenditure strategies, and instead favouring a growth-inducing structural reforms approach that fits well with SA's constrained budget parameters.

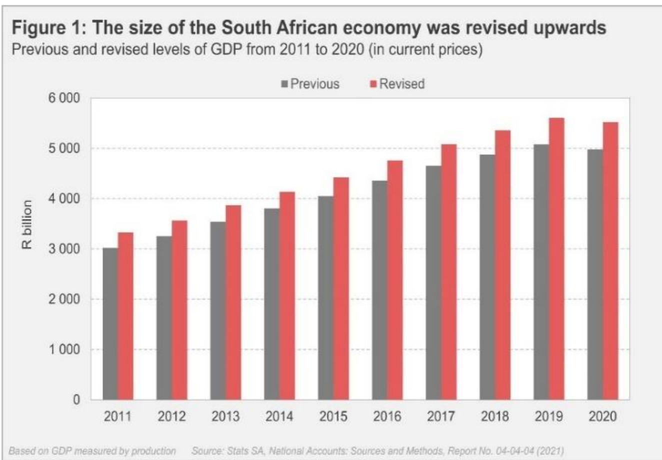
Super-Cycle Mining Profits Drive Tax Windfall, Narrower Budget Deficit

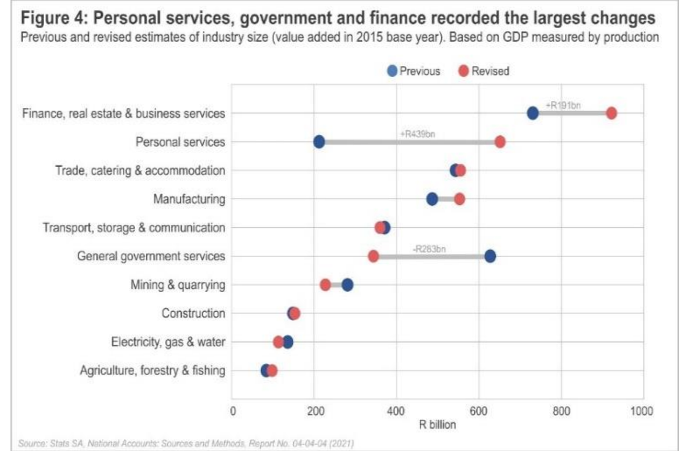
Throughout the year, estimates for the tax windfall have been steadily increasing and coalesced around the R140-169bn mark in the weeks leading up to the meeting – leaving scope for a R70-100bn overrun when R60bn in Covid and unrest costs are deducted. Mining profits as a share of corporate taxes rose from the typical 5-10% to roughly 25% this year in line with the 1H21 surge in commodity prices.

Deficit metrics have also outstripped expectations for the 2021/22 fiscal year, with median estimates aligning with a budget deficit of 7.1% of GDP (SARB: 6.5% exp) against the Feb 2021 assessment of 9.3%. In August, the deficit narrowed to 7.4% of GDP, reaching the targets set for 2023 almost 18 months ahead of schedule in a clear sign that plans to curb expenditure have been paying dividends. New estimates also see the primary budget deficit narrowing to 5.9% of GDP in 2022 & 4% by March 2024 -fuelling a more optimistic fiscal outlook over the medium-to-longer term.



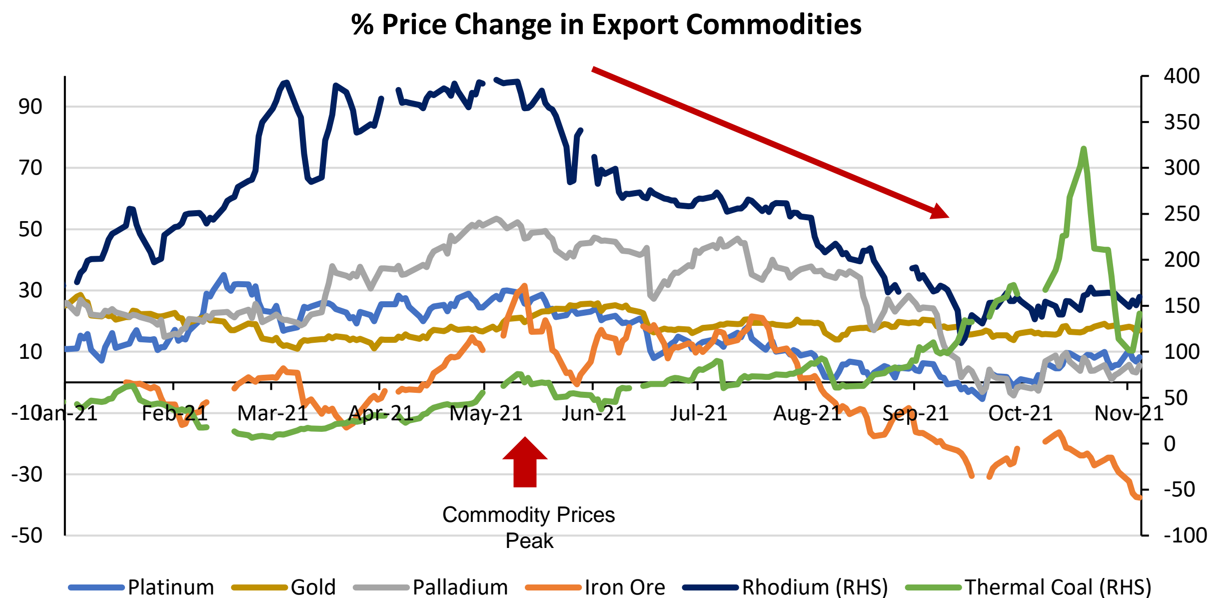
Moreover, the recent GDP rebasing (Aug 2021) that boosted the overall economy size by 11%, helped smooth debt:GDP metrics – bringing FY21 estimates down from 82.5% of GDP to 71-73%. Meanwhile, longer-term forecasts for the peak in debt:GDP metrics have also been revised notably lower to 77-82% by 2025-26 vs more pessimistic prior expectations for a peak in the 88-100% range in 2024-26. This is due partly to government's efforts to curb the public sector wage bill, after months of arduous negotiations with unions that eventually culminated in a win for government. Although this issue is not fully concluded, Risks remain to an unbudgeted R80-85bn pay out, should the ConCourt rule in favour of unions in the 2018 wage agreement – although this is not our base case.





Source: SA Treasury

Nevertheless, while 1H21 produced robust revenue flows, the recent rollover in commodity prices is an important reminder of the temporary and volatile nature of the commodity cycle. This windfall is expected to fade going into 2022, giving rise to concerns over delivering more permanent social support measures on a temporary windfall that could leave SA vulnerable on the fiscal front on a narrowing of tax revenues. This brings us to grants.



Grants, Grants, Grants – Godongwana Keeps the Reins Tight

The talk of the town for this MTBPS is all about grants and how Treasury will allocate windfall revenues to best counter rampant unemployment and social distress in the wake of the Covid-19 crisis and social unrest in July. While the pressure is on for Godongwana to pump the populist approach and cave to demands for a basic income grant, he has shown little appetite to do so – citing grant-dependency as a key constraint to achieving a more robust and inclusive grassroots recovery. Moreover, high debt servicing costs and a lack of debt stabilisation remain persistent thorns in the side of potential growth (as reflected in the current ~2% output gap) – keeping Godongwana from opening the taps too much at this MTBPS.

Here, we see him favouring a more targeted approach with something akin to a jobseekers grant aimed at offsetting SA's endemic unemployment crisis (34.4% in 2Q21). Unemployment remains SA's Achilles heel with the broader metric including discouraged workers estimated at 44.4% with youths aged 15-24 most affected at 74.8% unemployed. Similar to Mboweni, Godongwana believes that the best way to generate growth is through structural reforms and fostering long-term sustainable FDI, rather than unaffordable handouts and hot money flows.

Hence, the jobseekers grant may prove more effective than a blanket universal grant in addressing rampant unemployment – which was advocated by the World Bank in a recent research report. Analysts estimate the grant could cost between R30-35bn or approximately 0.3-0.5% of GDP/yr, boosting social spending as a percentage of revenue to 2-3% above pre-virus levels. There has also been talk of a 'family grant' which would be given directly to the head of the household, instead of individuals. This narrows the scope of the original SDR grant from 9m people to 1m, and while it may relieve some pressure on the fiscus, its permanence is of concern and could also draw both social discontent to pull support away from Ramaphosa at a time when the ANC is critically vulnerable following weak municipal election results.

Ailing SOEs Require Unbudgeted R12-15bn, Eskom Unbundling & Just Transition in Focus

On the SOE front, we expect Godongwana to follow on from his predecessor in holding off on major bailout packages for SOEs, outside of those suffering from immediate liquidity crises. Eskom remains the primary focus, with its R404bn debt load and fleet of ailing plants skimming 3% off FY21 GDP as a result of extensive load-shedding and deteriorating plant performance.

The Eskom discussion will centre around unbundling progress, and hopefully deliver some details on the just transition away from coal that was agreed with Western nations at the COP26 summit. This includes the provision of $8.5bn in concessional financing and grants aimed at expediting the decommissioning of Eskom's coal fleet towards more sustainable methods. Meridian economic recent study found that the Treasury could save R100bn over 25 years (on NPV basis) by accelerating the closure of coal plants in return for cheap loans and could be the solution to SA's chronic energy stability issues. Deputy FinMin Masondo also floated some Eskom debt forgiveness options in exchange for commitments to more ambitious climate goals, but few developments have been noted in this regard.

On the reform front, energy security will likely be at the top of Govt's priorities, given the ANC's weak showing in local elections at the hands of extensive load-shedding. The decision for Ramaphosa to boost license exemptions on the self-generation threshold from 1-100mw of power, was a positive step in the right direction, but will need to be complimented with further efforts to boost energy supply and stability.

Beyond Eskom, we see the Treasury dishing out R13-15bn in funding to offset the most vulnerable SOEs liquidity constraints – targeting Denel, Sarisa & and the Land Bank. State insurer, Sarisa, should gain the lion's share of this to offset claims for around R20bn following July's period of social unrest. Nevertheless, the Treasury will likely keep the reins tight here as it has in recent years on ailing SOEs with Mboweni putting an end to the era of blank checks and endless bailouts in favour of funding reprioritisation from other budgets and this year's windfall.

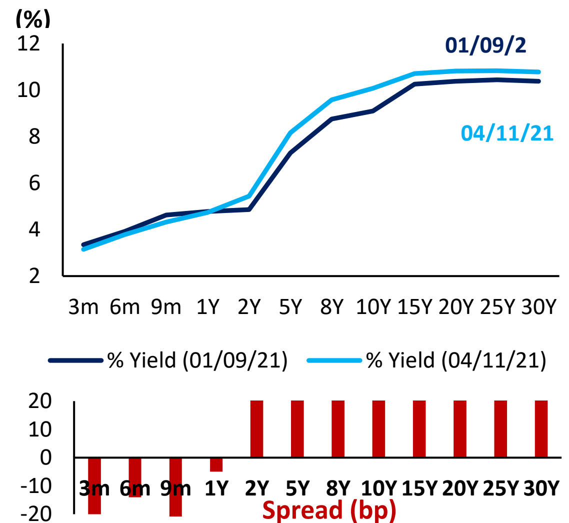
Tax & Issuance – Treasury May Pump the Brakes (slightly) on Borrowing

In terms of taxes, we're not expecting anything major in terms of guidance towards Feb, with Godogngwana well-aware of how the already-anaemic tax base has narrowed during the pandemic. Any potential changes will likely be minor, and be discussed

prior to the Feb 2022 main budget. On issuance, we may see the Treasury ease up in line with new more moderate deficit forecasts of 5.9% in 2022 & 4% by 2024.

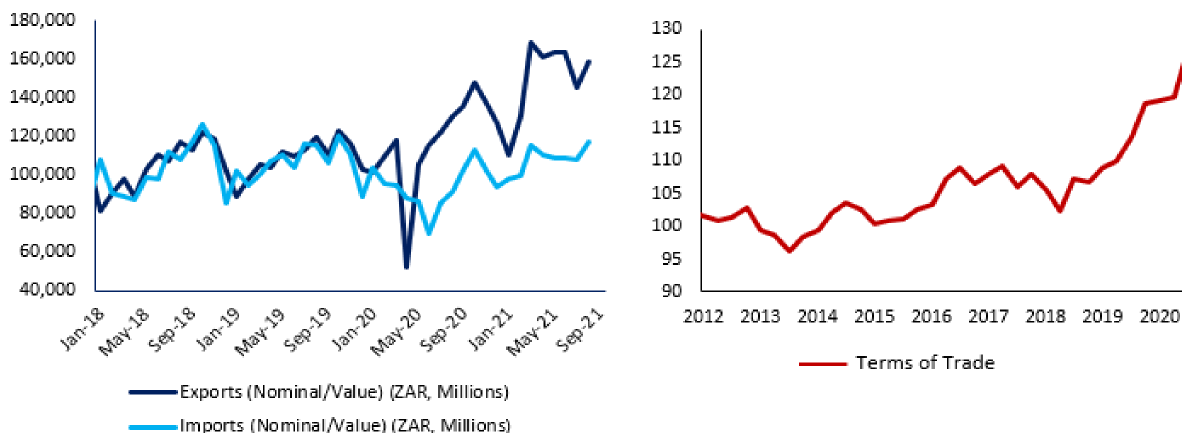
Markets

Going into this meeting, we have ZAR trading on weaker footing on the back of election uncertainty and broad-based risk-off going into the November FOMC with the Fed announcing the start of QE tapering at $15bn/m starting by the midpoint of the month. Since the start of September, ZAR has fallen -4.96% vs the USD – standing among the worst performers in the region, given its high-beta status.



Similarly, SAGBs have struggled to gain traction with foreigners steering clear since the start of September, with hakwish Fed and local inflationary concerns also marring demand. As a result, the local term structure stands higher across the breadth, with weakness concentrated in in the belly of the curve (5-10Y tenors) – positioned +85-102bp higher at the time of writing.

High vol-adjusted carry, attractive terms of trade and a strong current account surplus were the primary drivers of SA asset outperformance in 1H22, all of which have narrowed on higher oil prices, lower PGMs and a downturn in growth expectations – with a particular focus on China. Moreover, relative value plays targeting central bank divergences (ex. CBR vs SARB) have drawn risk flows away from SA assets since the start of September.



Elections & Fed in the Rear-View: MTBPS & Accommodative Come Into Focus

With the primary risk events for early November in the rear-view mirror, markets can now start pricing the more favourable fiscal picture discussed above into the outlook. Although the high number of municipal coalitions (50+) creates a complicated political framework for SA to navigate towards 2024, the monetary/fiscal outlooks should attract more attention in the near to medium-term.

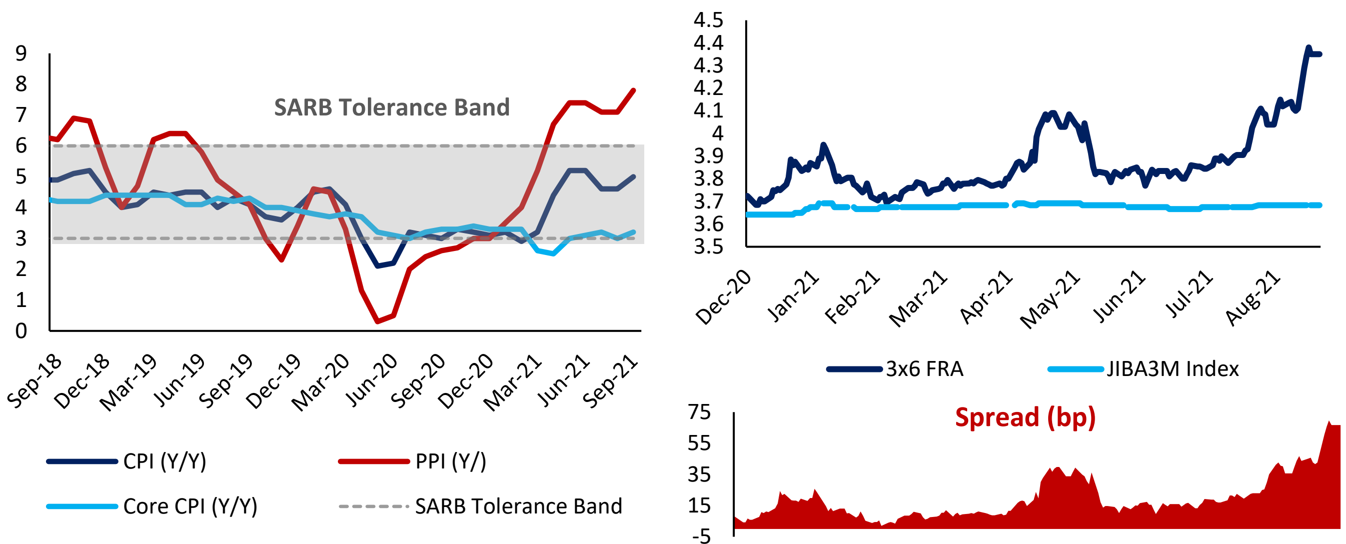
Here, we may see markets showing renewed interest in duration bets towards the back end of the curve (10-30Y), with the deficit outlook improving markedly towards 2025. This, however, is broadly contingent on the grants discussion as the primary focus of the meeting. A tighter approach from Godnogwana in producing a target jobseekers grant, and a more moderate and possibly flexible family grant, while turning the screws on the public sector wage bill should be received well by markets.

Conversely, a move towards more permanent and unaffordable social support (not our base case), should be received less positively.

Additionally, the recent COP26 deal represents a major long-term development in terms of Eskom and the country's sovereign risk profile – coming well ahead of market expectations with little to no opposition from DM nations. How this, in conjunction with Eskom's unbundling plans, is managed could be a significant driver of sustainable growth for SA and ease some concerns about the deteriorating energy supply trajectory. Nevertheless, given SA's poor track record here, this will need to be monitored before getting too upbeat.

Forward Rates Priced For Hawkish SARB: Front End May See Dovish Repricing

On the monetary policy front, we have scope for some front-end volatility into year-end with market pricing diverging substantially from policy expectations among locals. 3x6 FRA-Jibar spreads have accelerated higher from September to reach +66.7bp, diverging slightly from 5 & 10Y breakeven rates that stabilised around mid-October in line with falling oil prices. SARB Governor Kganyago highlighted oil prices as the primary driver underpinning possible upside forecast revisions, but reiterated a focus on the medium-term disinflationary trajectory (2022 Ave CPI exp at 4.2%, 2023 at 4.3%).



Given impact of the wide output gap and acute unemployment crisis in exacerbating the weak aggregate demand impulse, the SARB will be hard pressed to hike rates in 2021 in the absence of a notable move above the upper threshold of the 3-6% target range. This leaves scope for a repricing of the front-end lower following the meeting – although Governor Kganyago may retain his hawkish guidance to avoid sounding too dovish. When combined with the rosier fiscal picture, this paints a more constructive picture for SAGBs & ZAR assets into year-end.