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South Africa 2018 Budget

Tepid consolidation despite VAT hike

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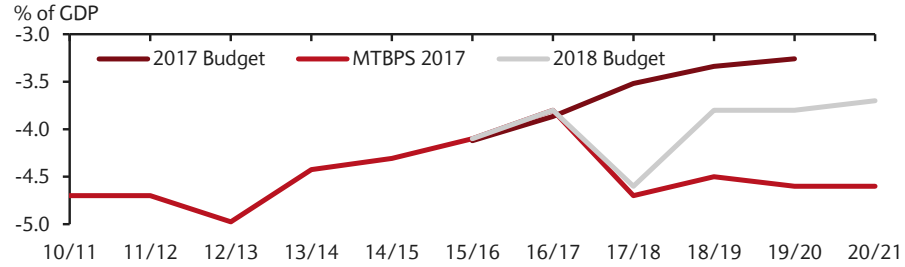
- Contrary to our expectation, the National Treasury has hiked VAT by one percentage point to 15%, which will generate roughly 2/3 of a substantial additional revenue collection target of ZAR36bn, with the remainder coming from a mix of personal income tax, higher "sin taxes" and fuel levies. The Treasury is optimistically expecting a quick rebound in tax buoyancy, which risks being slightly disappointed, in our view.
- The now former President Zuma's surprise promise in December to introduce free university education has meant that overall expenditures could not be trimmed substantially. We think that upside spending risks in several areas remain material, not least in current public sector wage negotiations, and further possible demands for bailouts from state-owned enterprises. Without a strong mechanism to control the public sector wage bill – either through a pay freeze or a programme to downsize headcount – we believe big gains on expenditure control will be difficult.
- The deficit consolidation path remains weak, with the main budget primary balance only approaching zero in 2020/21. Treasury projects the consolidated budget deficit to narrow from a projected 4.3% of GDP in the current fiscal year to 3.5% by 2020/21. The National Treasury do not envisage a peak in the debt to GDP ratio within the forecast horizon, but instead forecast it to hit 56.0% of GDP by 2020/21.
- Despite the weak consolidation path, we think the VAT hike combined with a building reform momentum behind Ramaphosa's rapidly consolidating political power should be enough to stay Moody's hand in its upcoming rating review. However, the ongoing structural challenges at Eskom and the clear difficulty in putting South Africa's fiscus back in balance means that a downgrade still cannot be ruled out.

FIGURE 1

Projected main budget deficit: better than the MTBPS but still too wide



Source: National Treasury, Absa Research

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2018/19 Budget was formulated in something of a political vacuum

The 2018/19 Budget was formulated during a period of exceptional political uncertainty while the two factions in the National Congress (ANC) struggled for dominance at the December electoral conference, and afterwards when President Ramaphosa manoeuvred to lever his predecessor, Jacob Zuma, out of the Union Buildings. Only very recently has President Ramaphosa's reformist "camp" emerged fully dominant and in control over the party and the state. Thus, most of the fiscal programming occurred in something of a political vacuum and we think the 2018 Budget reflects this to some degree. Against this backdrop, and given general elections due in a little more than a year's time, we had argued that it would be hard for the National Treasury (NT) to craft a budget that fully satisfied the imperative of fiscal consolidation and, at the same time, which was sufficiently palatable enough to placate a restless electorate. While many of the details of the 2018/19 Budget were different from what we had anticipated, our overall expectation of a weak consolidation approach was broadly validated. The rest of this report examines the 2018 Budget in more detail.

A stronger expected macroeconomic backdrop, perhaps mildly optimistic

National Treasury's assumption of higher growth relies on a strong boost from higher confidence

The economic growth assumptions underlying the NT's fiscal framework are still slightly optimistic, in our view, although perhaps not as much as they have been in previous budgets. Still, considering the additional fiscal consolidation measures tabled in this Budget, the NT's projection of real growth of 1.5% this year is quite a bit stronger than its MTBPS projection of 1.1%. The NT's expectation of stronger growth in the near term seems to be largely predicated on the view that a return of confidence will propel domestic demand, adding as much as 0.5pp to annual GDP growth. Notably, it now expects gross fixed capital formation to grow by 1.9% in 2018, compared to its previous projection of 0.5%. Growth in gross fixed capital formation is expected to pick up further over the coming years, rising to 3.3% and 3.7% in 2019 and 2020, respectively. However, we think that the improvement in business confidence will only be sustained if the apparent current optimism is validated by actual progress on relieving various binding infrastructure constraints and weak policies. Interestingly, the NT attempts to quantify the effect on potential growth of a few key reforms; it estimates that telecoms reforms to free up broadband spectrum, reduced barriers to entry through enhanced competition policy, improvements to transport and support for tourism and agriculture could add a combined 1.7 percentage points to potential growth.

NT's projections on household consumption expenditure in particular look optimistic

Even with the additional tax increases announced in this year's budget, the NT seems to believe that these will be more than offset by improving confidence. It forecast household consumption expenditure growth of 1.5% this year, improving further to 1.9% and 2.3% in the following two years. We find this somewhat optimistic. Although weak confidence has weighed on consumers, the lack of job growth and a subdued credit cycle could remain fundamental drags on spending momentum. As such, we see some downside risks to the National Treasury's GDP growth projections.

Higher inflation projections for the current year owe mostly to the VAT and general fuel levy hikes

Headline CPI inflation is projected to be 5.3% this year, with 0.6pp of this coming directly from the proposed tax measures. Headline CPI inflation is projected to average 5.4% and 5.5% in the following two years. These projections are barely changed from those tabled in the MTBPS is October last year, even with an output gap that is closing faster, owing possibly to the offset of lower electricity tariffs and a stronger exchange rate. Our own CPI inflation forecasts, which account for the adjusted fuel levy but do not yet include a VAT increase and a sugar tax, are 4.8% in 2018 and 5.5% in 2019, but we are probably more bearish than the National Treasury on the exchange rate. The pre VAT and sugar tax CPI inflation forecasts of the SARB stood at 4.9% for 2018 and 5.4% in 2019 but these also factored in a markedly weaker exchange rate.

FIGURE 2

Macroeconomic projections are perhaps slightly optimistic, but not entirely unreachable

	2016	2017			2018			2019			2020		
	Actual	Budget	MTBPS	Absa	Budget	MTBPS	Absa	Budget	MTBPS	Absa	Budget	MTBPS	Absa
Real GDP	0.3	1.0	0.7	0.9	1.5	1.1	1.4	1.8	1.5	1.7	2.1	1.9	1.9
Household consumption	0.8	1.3	1.0	1.3	1.7	1.2	1.3	1.9	1.6	1.7	2.3	1.9	2.0
Gov't expenditure	2.0	0.0	0.9	0.3	-0.3	1.7	0.4	1.2	1.0	0.5	1.4	1.0	0.5
Fixed investment	-3.9	0.3	-0.6	0.2	1.9	0.5	1.3	3.3	3.0	2.7	3.7	3.5	3.2
Exports	-0.1	1.5	2.5	0.8	3.8	3.2	2.2	3.4	3.4	2.1	3.5	3.5	1.7
Imports	-3.7	2.7	4.0	1.9	4.4	3.1	1.1	4.6	3.5	2.2	4.5	3.8	2.1
Nominal GDP (ZARbn)	4359	4604	4602	4614	4941	4889	4886	5298	5222	5216	5705	5612	5591
CPI	6.3	5.3	5.4	5.3	5.3	5.2	4.8	5.4	5.3	5.5	5.5	5.5	5.5
CA (% of GDP)	-3.3	-2.2	-2.3	-2.0	-2.3	-2.6	-2.3	-2.7	-2.9	-2.9	-3.2	-3.1	-3.3

Source: National Treasury, Absa Research

Revenue side of the budget is strong with a one percentage point hike in VAT

Projected revenue shortfall this year is a little smaller than expected at the time of the MTBPS

After the surprise announcement that it would under-collect tax revenues by ZAR50.6bn in FY2017/18, a moderate improvement in economic activity resulted in slightly better-than-expected tax receipts. This is in line with our observation that the overall run-rate on tax collections had improved in recent months and could result in a small overshoot of the MTBPS target. The NT now projects that tax revenue collections will only be ZAR48.2bn lower than its initial estimate in the 2017 Budget, mainly because of some rebound in corporate income tax and customs duties. However, it expected further shortfalls from the MTBPS projections on VAT (revised lower by ZAR2.2bn), dividend withholding taxes (revised lower by ZAR2.2bn) and personal income tax, although the shortfall is relatively small at just ZAR0.3bn. The overall underperformance in tax revenue collections leaves the overall tax buoyancy rate at 0.96 in FY 2017/18, notwithstanding the additional tax measures worth ZAR28bn that were implemented in the 2017 Budget. The NT attributes a large part of this to the shortfall in dividend withholding taxes after taxpayers (particularly trusts) shifted revenues to the previous year following the introduction of the higher rate in last year's budget. The NT assumes that the tax buoyancy rate will rise to 1.51 in FY 2018/19, owing largely to the effect of the additional tax measures tabled for this fiscal year. The buoyancy rate is then seen normalising to 1.13 in the next two fiscal years. However, the NT notes that tax morality has declined in recent years due to the lack of response to allegations of corruption in government. The NT also reiterated President Ramaphosa's message that a commission of enquiry to look into governance issues at South African Revenue Services, but fixing the institutional issues at SARS may not be easy without new leadership, and the current head of SARS's term likely continues through to September 2019.

FIGURE 3

Likely 2017/18 revenue shortfall looks a little lower than it did at the MTBPS

ZAR bn	Budget '17	MTBPS '17	Current estimate	Shortfall vs Budget	Shortfall vs MTBPS
Personal income tax	482.1	461.3	461	-21.1	-0.3
Corporate income tax	218.7	213.9	218.1	-0.6	4.2
Dividend withholding tax	34.2	31.6	29	-5.2	-2.6
VAT	312.8	301.3	299.1	-13.7	-2.2
Fuel levy	70.9	70.1	71.3	0.4	1.2
Taxes on international trade	52.6	47.2	50.2	-2.4	3.0
Gross tax revenue*	1265.5	1214.7	1217.3	-48.2	2.6

Note: *includes other taxes. Source: National Treasury, Absa Research

A one percentage point hike in VAT accounts for roughly two-thirds of the additional tax measures penciled in for 2018/19

FY 2018/19, the NT has tabled measures to raise an additional ZAR36bn in tax revenues, with a strong reliance on consumption taxes. Against our expectation, the NT has proposed to increase VAT rate by one percentage point to 15%. This is the first time the VAT rate has been increased in South Africa since 1993. Even with the adjustment, South Africa's VAT remains lower than the global average of similar sales taxes. The increase in the VAT rate is expected to raise additional revenue of ZAR22.9bn in FY 2018/19. The NT argues, correctly in our view, that a VAT increase was the least economically damaging way to raise the needed tax revenues. The ad valorem excise duties on luxury goods are also set to rise. For motor vehicles, the ad valorem excise duty rises from 25% to 30%. Meanwhile, the ad valorem excise duty rates, presently at 5 and 7% are to be hiked to 7 and 9%.

The government has raised additional revenue by not adjusting income tax brackets to fully offset the effects of inflation

The NT did not make further adjustments to personal income tax rates, a development that possibly reflects its dim view on tax morality. However, the top-four personal income tax brackets are completely unadjusted for fiscal drag while the bottom-three brackets will benefit from a below-inflation adjustment. As a result, the NT expects to collect an additional ZAR6.8bn from personal income taxes. Moreover, the NT has announced an increase in the estate duty from 20% to 25%, in line with the recommendations from the Davis Tax Committee. As a measure to limit donations designed to avoid the higher rate of estate duty, donations above ZAR30mn in a single tax year will be taxed at 25%. These measures are to be effective from 1 March 2018. However, the revenue impact is relatively small with the NT projecting it would collect an additional sum of just ZAR150mn in 2018/19. The medical tax credits are also set to rise at less than the rate of inflation, which is set to help fund the rolling out of national health insurance.

Sin taxes and fuel taxes also contribute to the revenue raising effort

As is often the case, "sin taxes" are to set to rise by more than the inflation rate. The increase in excise duties on tobacco is projected to raise an additional ZAR0.9bn while the rise in the excise duty on tobacco is forecast to increase revenue above the baseline by ZAR0.4bn. Fuel levies are also set to rise sharply by 52cents/litre. The only component that is included in the main budget revenue is the general fuel levy, which is rising by 30c/l, raising an additional ZAR1.2bn. The balance goes towards the Road Accident Fund levy. As previously announced, the sugar tax, termed the "health promotion levy", is due to be introduced from 1 April 2018, generating ZAR1.9bn in revenues in FY2018/19.

FIGURE 4

2018 Budget proposes ZAR36bn extra revenues, two thirds from a VAT hike

Tax measure	ZAR bn
Direct taxes	**7.3**
Personal income tax	7.5
Income adjustment for fiscal drag	6.8
Medical tax credit adjustment	0.7
Estate duty increase	0.2
Indirect taxes	**28.7**
Increase in VAT	22.9
Increase in general fuel levy	1.2
Increase in excise duties on alcohol & tobacco	1.3
Increase in ad valorem duties	1.0
Increase in environmental taxes	0.3
Sugar tax ("health promotion levy")	1.9
TOTAL	**36.0**

Source: National Treasury, Absa Research

Total expenditures have been trimmed by less than ZAR9bn in 2018/19 compared to the projections of the 2017 Budget

Free university education has undermined the expenditure containment

If the revenue side of the budget is a little stronger than we expected, the overall expenditure side still appears relatively weak, in our view, although this is hardly surprising given various developments since the MTBPS was introduced in October. In November, Finance Minister Gigaba announced that the presidential fiscal committee had identified ZAR85bn worth of spending cuts over the three-year medium-term expenditure framework, with Gigaba promising ZAR25bn for the upcoming fiscal year. This latter amount seemed to be on top of the ZAR31bn spending cuts promised but not detailed in previous fiscal iterations, thus seeming to suggest as much as ZAR56bn of spending cuts in FY 20118/19. However, these statements came before Zuma's surprise announcement of free university education and escalating drought pressures. Thus, previous commitments to cut the overall baseline expenditure envelope dramatically have been quietly shelved. Thus, the expenditure projection, compared to the numbers envisaged in the 2017 Budget, is only ZAR.8.6bn smaller this year and ZAR18.8bn smaller in 2019/20.

FIGURE 5

Expenditure ceilings were breached in 2017/18, and trimmed only slightly in 2019/19

ZARbn	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
2013 Budget Review	1093					
2014 Budget Review	1091	1168				
2015 Budget Review	1081	1153	1250			
2015 MTBPS	1078	1153	1250	1354		
2016 Budget Review	1077	1153	1240	1339		
2016 MTBPS	1075	1144	1230	1323	1435	
2017 Budget Review	1075	1144	1230	1324	1435	1524
2017 MTBPS	1075	1142	1234*	1317	1420	1524
2018 Budget Review	1075	1142	1233*	1315	1417	1524
Changes since 2017 Budget	-	-	2.9	-8.6	-18.8	0.3

Source: National Treasury, Absa Research

While there have been cuts in a number of areas, spending has been lifted in others, including the provisions for higher education:

- an extra ZAR12.4bn to fund free higher education for poor and working class students (rising to ZAR20.3bn next year and ZAR 24.3bn in 2020/21). This is on top of a ZAR10bn provisional allocation made in the 2017 Budget to fund the tuition freeze:
- an additional ZAR4.2bn for National Health Insurance and ZAR1bn for preparatory work for the 2021 Census;
- an additional ZAR2.6bn to fund an above-inflation increase in social grants to offset the impact of the VAT increase on the poor;
- a provisional allocation of ZAR6bn for drought relief, with amounts be allocated in the adjustments budget; and
- an uplift in the contingency reserve, compared to the MTBPS of ZAR10bn over three year planning horizon, with ZAR5bn of the uplift happening in the upcoming fiscal year

FIGURE 6

Higher spending on free tertiary education offset most other spending cuts

	2018/19	2019/20	2020/21	MTEF
2017 Expenditure ceiling	**1323.6**	**1435.4**	**1523.5**	**4282.5**
Reductions in baseline from MTBPS	-26.4	-28.8	-30.5	-85.7
New spending allocations in 2018 Budget	14.0	23.2	30.2	67.3
Higher education	12.4	20.3	24.3	56.9
National Health Insurance	0.7	1.4	2.1	4.2
Increased social grants to offset VAT hike	0.3	0.2	2.1	2.6
2019 elections and 2021 Census	0.2	1.1	1.6	2.9
Other	0.4	0.1	0.1	0.5
Changes to contingency reserves & 2017 provisional allocations	-2.1	-13.1	0.5	-14.8
2018 provisional allocation (for drought)	6.0	-	-	-
2018 Expenditure ceiling	**1315.0**	**1416.6**	**1523.8**	**4255.4**
Changes from 2017 Budget	-8.6	-18.8	0.3	-27.1

Source: National Treasury, Absa Research

Upside spending risks remain

Additionally, we think there are still material upside spending risks. As regards free university education specifically, we are concerned that the government's numbers may not factor in the possible unwillingness of poor and working class students who entered university a year or two ago to continue to pay as the programme is phased in only sequentially starting this year for new entrants. Nor does the Budget detail a response to likely increased demand for seats at universities from academically qualifying students who may previously not have attended university due to budget constraints.

Demands for funding from troubled state-owned companies are another source of upside spending risk

Interestingly, the 2018 Budget makes no provision for further bailouts for state-owned companies (SOCs), even though a number, such as Denel, SABC and PRASA could conceivably request new funds from the NT. Moreover, the 2018 Budget states explicitly that the finances of SANRAL remain weak due to ongoing opposition to the Gauteng Freeway Improvement Project and that SANRAL "may require recapitalisation in 2018/19". The 2018 Budget notes that the expenditure ceiling breach of ZAR2.9bn in 2017/18 was due to the ZAR13.7bn bailouts for South African Airways (SAA) and the South African Post Office (SAPO). We continue to view the possible demands from SOCs for funding as a major upside spending risk, even though the government appears to be taking a tougher tone in some respects, acknowledging for example that the business models of some SOCs are unsustainable and that a holistic reform program would require restructuring perhaps with private equity investment. We were struck by the absence from the 2018 Budget document itself of the promise in previous fiscal iterations that SOC bailouts would only be done in a deficit-neutral manner through the sale of assets. Finance Minister Gigaba's speech, however, was a little more promising in this regard, stating that a property audit by the Department of Public Works showed the national government owning 195,000 properties worth ZAR40bn, which could be sold to help bail out struggling SOCs.

The public sector wage bill also remains a source of concern and upside spending risk

The 2018 Budget suggests that consolidated government expenditure on employee compensation should rise by 7.0% in the upcoming fiscal year, which is based on a wage settlement in the current pay talks that is benchmarked on CPI of 4.7% plus an average pay uplift of 1%, and then 1.5% for everything else, combined with some headcount reductions. But after implementing a one percentage point VAT hike, we think public sector unions may now be even less inclined to accept a pay settlement of just CPI + 1%. We think that without a strong tool to control public sector wage bill – either through a pay freeze or a programme

to downsize the public sector headcount – little headway can be made on expenditure control.

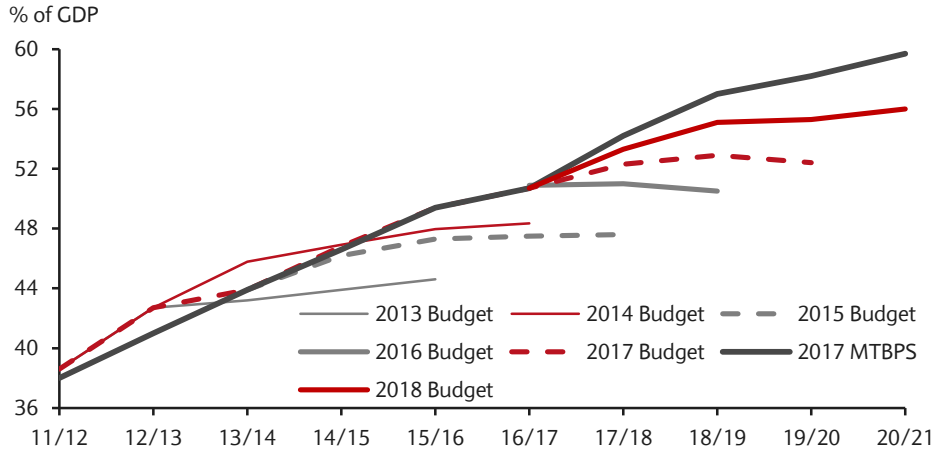
Fiscal consolidation: better than in the MTBPS, but still quite insufficient

Debt to GDP to continue rising over three year forecast horizon

The combination of the 2018 Budget's approaches on revenues (which we see as broadly strong) and expenditures (which we see as being weak, if for reasons which are entirely understandable given unforeseen events, such as drought or political transition), leaves a somewhat weak approach to overall fiscal consolidation. At present, the main budget primary deficit only approaches zero in the last year of the planning horizon, ie, 2020/21. Thus, the main budget deficit, projected at 4.6% of GDP in the current fiscal year, is only projected to fall by 0.9pp of GDP over the three-year planning horizon, to just 3.7% of GDP by 2020/21 (see Figure 1). Thus, there is no sign of the debt ratio peaking in the three year forecast horizon. Instead, gross loan debt to GDP is projected to rise from 53.3% at the end of March to 56.0% by end 2020/21 – even without any of the upside further spending risks materialising. NT says in the budget documentation that it expects debt to GDP to stabilize at 56.2% in 2022/23 but the fiscal and macroeconomic assumptions that lie behind this assertion are not clear.

FIGURE 7

Debt trajectory now looks set to hit 56% of GDP by 2020/21



Source: National Treasury, Absa Research

Return on equity of state-owned enterprises was just 0.3% in 2016/17

Return on equity for SOCs remains paltry

The 2018 Budget document contained, as usual, a chapter on the financial position of public sector institutions, including SOEs, social security funds, and development finance institutions. It makes for sobering reading, noting that the net asset value of SOCs had declined from about ZAR362bn in 2015/16 to some ZAR356bn in 2016/17, as liabilities grew faster than assets, while profitability, as measured by the return on equity, was a mere 0.3% in 2016/17, down from 0.8% a year earlier but better than -2.9% in 2014/15. The 2018 Budget reports that the six largest SOCs are projected to borrow about ZAR117bn in each of the upcoming two fiscal years, with Eskom accounting for a little over half of this figure. This section of the 2018 Budget reports broadly positive news for South Africa's three biggest development finance institutions, and for the social security funds as well, with the exception of the Road Accident Fund, which remains insolvent. As with previous budgets, this section has made all the right noises about restructuring and improving the governance of SOCs and restructuring them, but progress in this area is likely to remain slow, despite President Ramaphosa's hints in the State of the Nation Address last Friday, which could be taken as a sign that partial privatisation and public private partnerships will be considered increasingly.

Moody's now likely to hold off downgrading

Moody's likely to hold off on a further downgrade due to the VAT hike and the gathering reform momentum evinced as President Ramaphosa has consolidated his political control

Although the 2018 Budget includes some positive measures, such as a one percentage point VAT hike and more reasonable macroeconomic assumptions, the government's reluctance to pursue – in this Budget at least – radical expenditure cuts and balance sheet restructuring means that that South Africa still does not have a convincing answer to its fiscal challenges and slippery debt dynamics. Thus, South Africa's fiscus remains vulnerable to the same potential negative shocks as before: weaker-than-expected growth; crystallisation of contingent liabilities at state-owned enterprises (SOEs); and public sector wage discussions, which risk breaching the tight expenditure budget for public sector compensation. We are mildly disappointed in today's budget, despite the positive signal of the VAT hike. We have previously argued that Moody's was more likely than not to downgrade South Africa's Baa3 rating, but that the 2018 Budget would prove key. While we remain mildly disappointed with the fiscal consolidation effort in the budget, we think the adoption of a VAT hike will be taken as a positive signal by Moody's. Combined with the new management at Eskom and what appears to be a swiftly gathering reform momentum behind Ramaphosa's rapidly consolidating leadership, the VAT hike should thus probably tip the balance in favour of no further downgrade from Moody's, at this stage. However the slow pace of deficit consolidation and the lack of a concrete plan (yet) for addressing the huge structural challenges facing Eskom means that a downgrade cannot be ruled out.

FIXED INCOME STRATEGY

We believe that today's budget will just do enough to avoid a sub-investment downgrade from Moody's over the coming weeks, which previously was our base-case scenario. Accordingly, we are closing out our R2048/R2023 curve steepener recommendation at a 160bp (loss of 20bp) and our 10y/R186 pack recommendation at a 35bp (loss of 15bp) because today's Budget is supportive of a flatter curve. We are still constructive about 6-month T-bills and are happy to stick with our I2050/R212 curve steepener, 5v10 swap curve flattener and 15v30 swap curve steepener.

Borrowing estimates are revised lower and top out in 2019/20, but the National Treasury acknowledged that there are numerous risks to these revisions

The NT downwardly revised the estimated borrowing requirement, in nominal terms and as a percentage of GDP, during each of the next three fiscal years. More specifically, the borrowing requirement is now expected to be between R30-50bn lower per year over the next three years when compared to last year's MTBPS estimates. Although borrowing failed to drop below the February 2017 estimates, it was encouraging to see that the NT now expects gross borrowing to top out at R301bn (5.6% of GDP) in 2019/20, before moderating slightly to R282bn in 2020/21. The NT suggested that the four main risks to its latest borrowing estimates include: 1) an increase in contingent liabilities from SOEs; 2) inflation and exchange rate risk; 3) monetary policy tightening in developed markets; and/or 4) further credit rating downgrades. Although we no longer expect Moody's to downgrade the sovereign over the coming weeks, fears of downgrades could be rekindled later in the year if GDP growth fails to live up to expectations and/or if SOEs do indeed require additional assistance. We think that inflation and the exchange rate are linked closely to how the market absorbs the pace of developed market policy rate normalisation, not to mention that the ZAR has already rallied strongly this year, while the inflation cycle is about to bottom.

FIGURE 8

Borrowing requirement breakdown

	2017/18			2018/19			2019/20			2020/21		
	Budget (R'mn)	MTBPS (R'mn)	change (%)	Budget (R'mn)	MTBPS (R'mn)	change (%)	Budget (R'mn)	MTBPS (R'mn)	change (%)	Budget (R'mn)	MTBPS (R'mn)	change (%)
Borrowing requirement	**217,345**	**219,644**	**-1.0%**	**191,054**	**222,049**	**-14.0%**	**204,785**	**243,127**	**-15.8%**	**214,797**	**265,314**	**-19.0%**
% of GDP	-5.2%	-5.3%	0.1%	-4.5%	-5.4%	0.9%	-5.6%	-6.6%	1.0%	-4.9%	-5.8%	0.9%
Short term net issuance	**33,000**	**33,000**	**0.0%**	**14,200**	**21,500**	**-34.0%**	**22,700**	**29,000**	**-21.7%**	**30,000**	**36,000**	**-16.7%**
Treasury bills	43,000	33,000	30.3%	4,200	21,500	-80.5%	22,700	29,000	-21.7%	30,000	36,000	-16.7%
CPD	-10,000	–		10,000	–		–	–		–	–	
Long-term net issuance	**193,800**	**176,123**	**10.0%**	**159,916**	**185,388**	**-13.7%**	**149,153**	**188,622**	**-20.9%**	**152,672**	**199,159**	**-23.3%**
Gross issuance	195,274	200,700	-2.7%	191,000	231,800	-17.6%	200,500	247,500	-19.0%	208,900	255,000	-18.1%
Switches	-1,474	-1,030		–	–		–	–		–	–	
Redemptions	-24,577	-24,577	0.0%	-31,084	-46,412	-33.0%	-51,347	-58,878	-12.8%	-56,228	-55,841	0.7%
Foreign net issuance	**33,895**	**29,807**	**13.7%**	**35,932**	**40,278**	**-10.8%**	**-6,205**	**-6,811**	**-8.9%**	**29,398**	**32,243**	**-8.8%**
Gross issuance	33,985	33,895	0.3%	38,040	42,510	-10.5%	39,210	43,650	-10.2%	40,650	44,550	-8.8%
Arms procurement	1,111	1,111		–	–		–	–		–	–	
Redemptions	-4,121	-4,088	0.8%	-2,108	-2,232	-5.6%	-45,415	-50,461	-10.0%	-11,252	-12,307	-8.6%
Change in cash balances	**14,652**	**18,256**	**-19.7%**	**18,994**	**25,117**	**-24.4%**	**-39,210**	**-32,316**	**21.3%**	**-40,650**	**2,088**	**-2046.8%**

Note:* Positive (negative) outcome represents an increase (decrease) in cash balances. Source: National Treasury, Absa Research

Reduced issuance supports our constructive T-bill view

We expected the NT to reduce T-bill issuance from R21.5bn to R9.5bn during FY 2018/19 and on the back of these favourable supply dynamics, we recommended that investors buy 6m T-bills (see *Fixed Income Roadmap: reduce duration ahead of event risk* 5 February). However, the NT actually decided to reduce next year's net T-bill issuance to only R4.2bn, which helps to underpin our trade recommendation even further. Moreover, net T-bill supply will temporarily contract over the coming months, because the pace of issuance is

slowing at a time when some of the paper that was issued aggressively last year matures. Owing to last year's heightened risk of sovereign downgrades and funding constraints among some of the SOEs, the NT decided to ramp up T-bill issuance aggressively to generate more of a liquidity buffer to deal with the heightened event risk. The structural demand for T-bills from the banking sector (HQLA requirements) should also be conducive to tighter T-bill supply conditions. If policy rate cut expectations intensify and sovereign downgrade fears subside in the wake of the budget, we would expect T-bills to outperform other money market instruments like the FRA curve which is offering less of yield pick/risk premium. During FY 2019/20 and 2020/21 net T-bill issuance is projected to pick up to between R20-30bn, which will represent between 12-13% of total domestic debt, which is still comfortably below the 15% risk benchmark.

The National Treasury might struggle to reduce the pace of domestic debt issuance unless non-competitive allocations improve.

As expected, gross local currency bond issuance is likely to come up short of MTBPS estimates for the current fiscal year on the back of poor demand at the weekly linker and non competitive auctions (see *Fixed Income Roadmap: reduce duration ahead of event risk* 5 February). More specifically, the NT was only able to place 14% of additional paper in the non competitive auction, compared with the 20% allocations that were enjoyed in previous years. Linkers are expected to represent 20% of this year's overall local debt issuance, which is in keeping with historical averages. However, this would have been less had NT not upped the pace of linkers issuance by R100m to R900mn per week. Our gross issuance estimates for FY 2018/19 of R192bn were off by only R1bn, but because we were expecting fewer redemptions next year (on the back of more switch auctions), our net issuance estimates were higher than NT's revised estimates. Although NT indicated that there was scope to reduce the size of the weekly auctions, we believe that this will only be possible if there is an improvement in non-comp and linker allocations. Moreover, assuming 49 auctions for the year, NT will be able to raise R162bn worth of nominal bonds and R44bn worth of linkers if the current rate of issuance remains at R3.3bn and R0.9bn per week, respectively. Hence, if we exclude non-comp funding, then nominal and linker funding aggregates to R206bn. We have also accounted for an estimated discount of bond issuance of R10bn, which then implies R196bn worth of gross funding. If we include non-comp funding, which is currently running at 14% of the main auction, then the NT could get an additional R30bn worth gross funding. However, that implies that the size of the weekly nominal and linker auctions will only be reduced by R0.3bn to R3.0bn and R0.2bn to R880m, respectively. In the outer years, gross issuance continues to hover around R200bn, which again implies that if non-comp funding is disappointing and/or if redemptions struggle to decline, due to less switch auctions, there will be limited scope for the NT to significantly reduce the weekly auction sizes.

The NT could launch a 16y nominal and a 25y linker bond next year

The NT indicated that it will issue both a new fixed rate and a new inflation-linked bond during the next fiscal year. When it comes to the nominal bond curve, there are currently three year gaps between the R2035/R2032, R2040/R2037, R2044/R214 spreads and a four year gap between the R2048/R2044 spread. We believe that the NT is likely to launch a new bond between the R2035/2032 part of the curve because according to its weighted term-to-maturity risk benchmarks, fixed rate and T-bills are already close (13.2 years) to the upper limit of the 14-17 year benchmark range. Additionally, foreign investors already own just 50% of both R2032 (14y) and R2035 (17y) paper and, consequently, they could welcome a new bond alternative at that part of the curve. When it comes to linker bonds, we believe the NT is likely to plug the seven-year gap between the I2038 (20y) and I2046 (28y), which in turn could help address the sharp steepness/roll down that currently exists between these two bonds. Given that NT is at lower end (14.3 years) of its linker bond risk benchmark range of 14-17 years, we believe that it has the leeway to issue more duration inflation-linked scrip.

The NT is confident that it will be able to consistently place $3bn worth of hard-currency bonds per year over the next three years

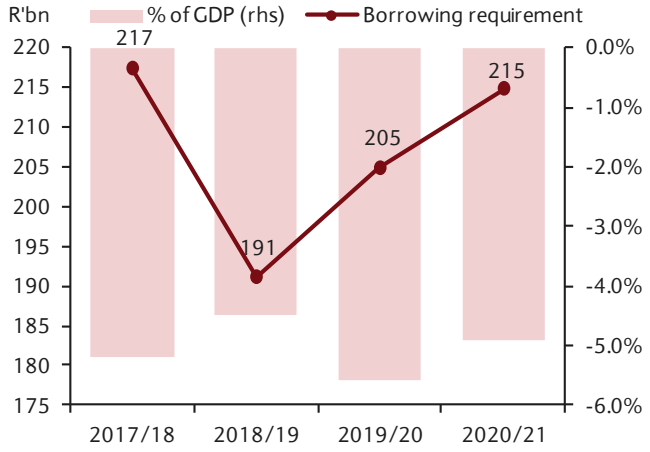
Critically, the NT has indicated that it will no longer use domestic bond issuance to help fund some of its hard-currency funding commitments (including coupon and interest payments), which should also encourage SAGB bulls from a supply dynamic. It is also reassuring that the NT has continued to accumulate cash in anticipation of the large USD bond redemption of R45bn that takes place in 2019/20, which also implies that rather more issuance will be used to redeem the bond. The fact that the NT has also signalled its intention to issue a ZAR-denominated Islamic bond during the next fiscal year should also put less funding pressure on the local debt market. Considering that hard-currency debt only represents 9.8% of total debt, which is well below the NT's risk benchmark of 15% and given that there is already elevated levels of foreign ownership in the local currency market, it stands to reason that the NT is willing to tap the hard-currency bond market to a greater extent over the coming years.

A 5% increase in prudential limits may also curb extended ZAR strength.

In an attempt to allow local investors to diversify their investment portfolios more effectively and in the interest of greater cross-border flow transparency and gradual exchange control liberalisation, the NT has decided to increase prudential limits by 5% for all investor types. More specifically, long-term insurers and collective investment schemes allowances will increase from 35% to 40%, while retirement fund allowances will increase from 25% to 30%. These bold measures, together with the increased hard-currency bond issuance mentioned above, collectively suggest that the authorities are confident that the ZAR will sustain the bulk of its recent gains. However, given that the ZAR is already strengthened considerably over the past couple of months, we think that local investors could take advantage of these levels to diversify abroad. During Q3 18, local assets under management eclipsed the R10trn mark (see *Fixed Income Strategy: Flows. Holdings and asset allocations* 20 February) for the first time ever. This implies that if local investors are currently at their maximum prudential limits and now decide to make use of the full additional 5% allowance, there could be R500bn ($40bn) worth of potential capital outflows. While we do not know for sure if investors are indeed at above or below their prudential limits, we do think that such a large outflow is unlikely to materialise because some local asset managers will not have the mandate to invest abroad. Nonetheless these measures are significant in magnitude and, as such, could be conducive to a weaker ZAR over the coming quarters.

FIGURE 9

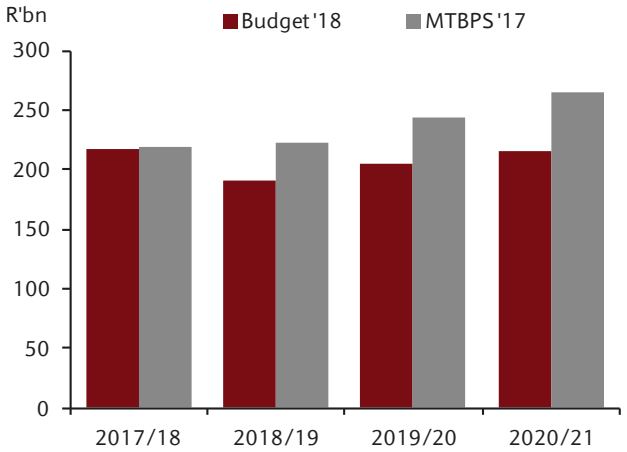
Borrowing requirement



Source: National Treasury, Absa Research

FIGURE 10

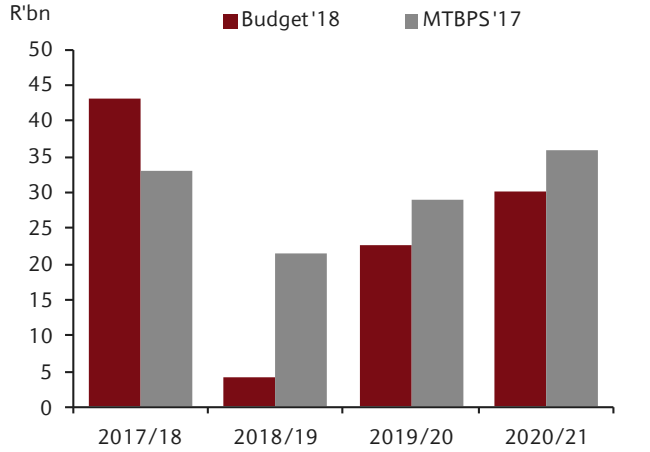
Borrowing requirement adjustments



Source: National Treasury, Absa Research

FIGURE 11

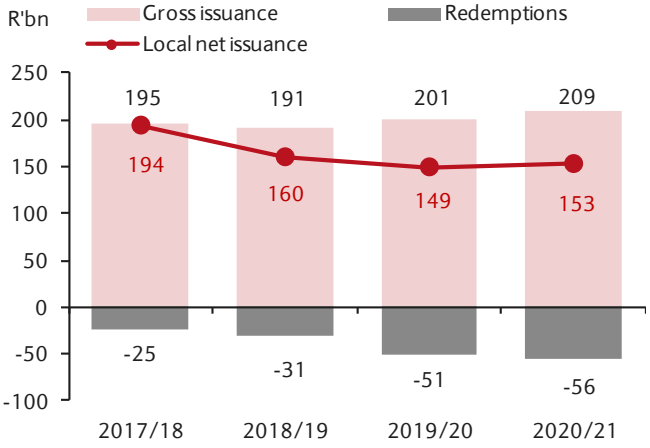
T-bills



Source: National Treasury, Absa Research

FIGURE 12

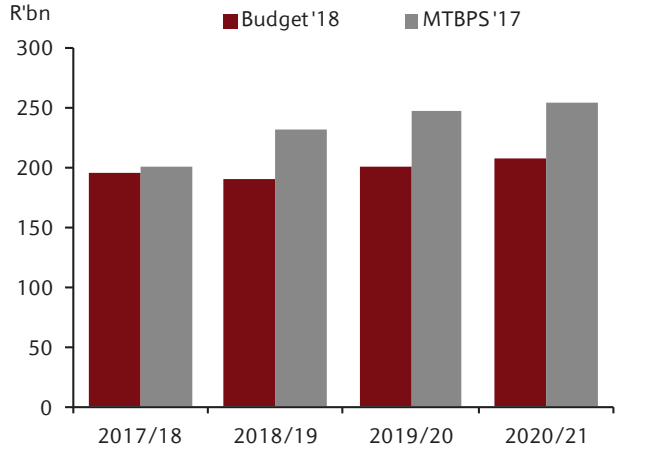
Local currency bond issuance breakdown



Source: National Treasury, Absa Research

FIGURE 13

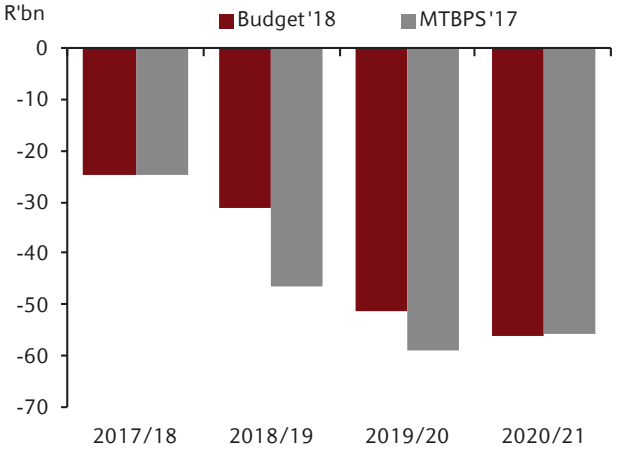
Local currency bond gross issuance



Source: National Treasury, Absa Research

FIGURE 14

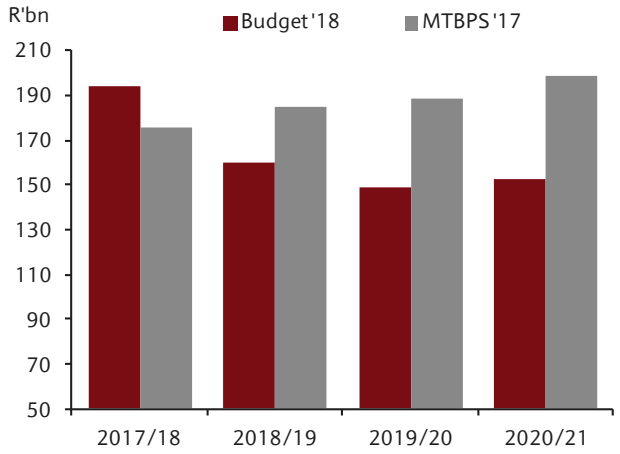
Local currency bond redemptions



Source: National Treasury, Absa Research

FIGURE 15

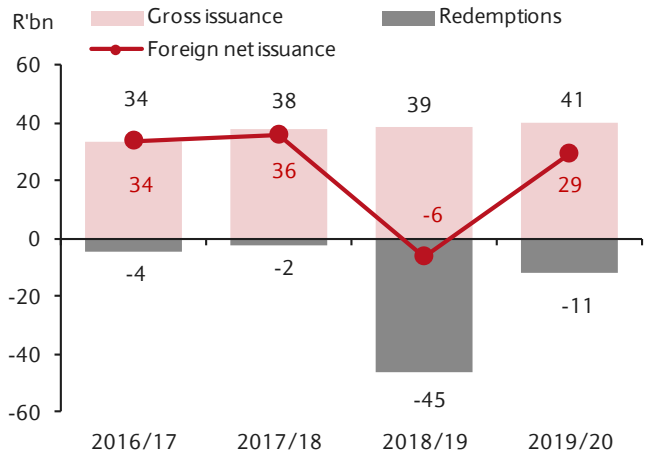
Local currency bond net issuance



Source: National Treasury, Absa Research

FIGURE 16

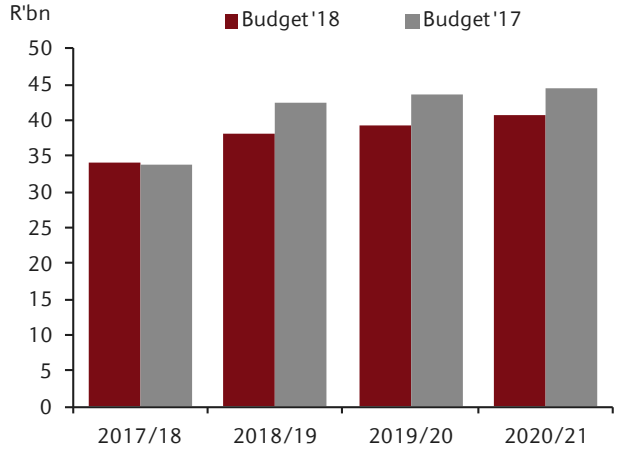
Foreign currency issuance breakdown



Source: National Treasury, Absa Research

FIGURE 17

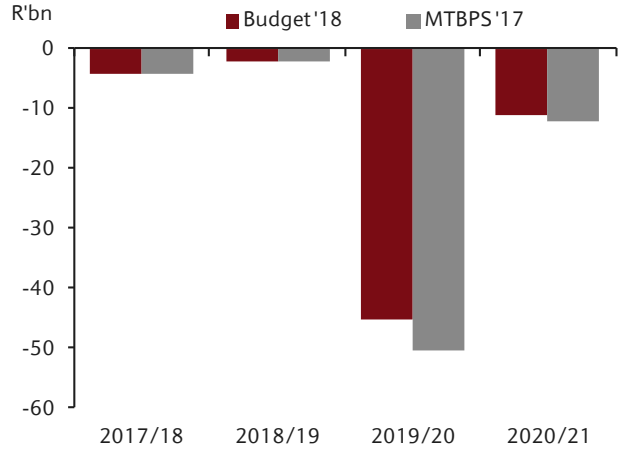
Foreign currency bond gross issuance



Source: National Treasury, Absa Research

FIGURE 18

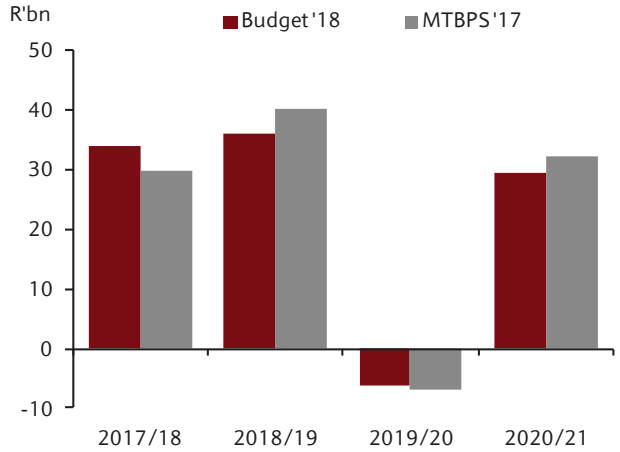
Foreign currency bond redemptions



Source: National Treasury, Absa Research

FIGURE 19

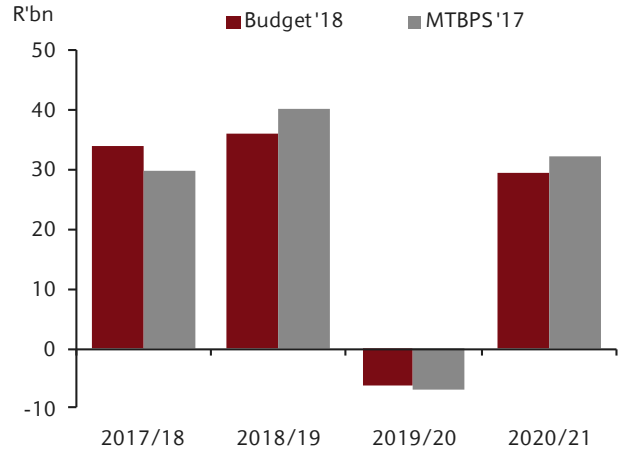
Foreign currency bond net issuance



Source: Source: National Treasury, Absa Research

FIGURE 20

Cash balances



Source: Source: National Treasury, Absa Research

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