momentum investments

in the moment

Herman van Papendorp
Head of Investment Research & Asset Allocation

Sanisha Packirisamy
Economist

Nine things to watch out for in the medium-term budget

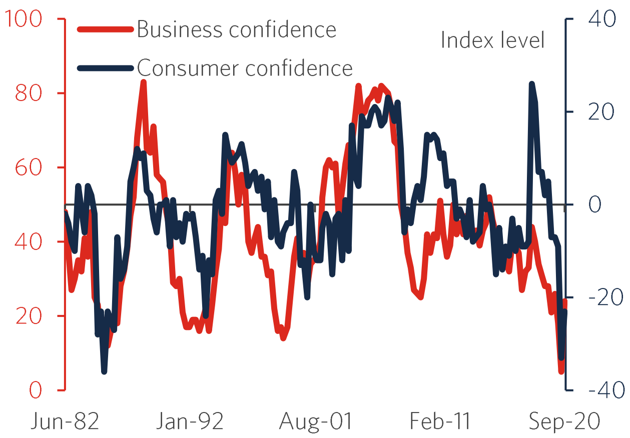
Highlights

1. **Post-pandemic nominal growth expectations:** We expect real growth to average negative 0.8% between 2020 and 2023 in comparison to Treasury's June 2020 forecast of negative 0.4%, given the high risk of load shedding into 2022 and a slow recovery in fixed investment back to pre-crisis levels. Inflation is however expected to materialise at a marginally higher level. As such, our forecasts on nominal growth are broadly in line with those of Treasury.
2. **Tax collection in a fragile growth environment:** The standstill in economic activity, triggered by the lockdown restrictions, had a detrimental effect on government revenue, while expenditure trends were only slightly weaker as government embarked on a countercyclical fiscal approach to prop up economic growth through spending.
3. **Developments in the ongoing public sector wage bill dispute:** The Organisation for Economic Co-operation and Development (OECD) showed that top managers in SA's civil service earn average revenue of nine times the per capita gross domestic product (GDP), which is far higher than the six times recorded for the OECD average. Efforts to stick to proposed wage bill cuts in order will elevate Treasury's credibility in our opinion.
4. **Ability to supplement pro-poor spending:** With the lockdown restrictions having negatively affected many households, calls for a basic income grant have been revived. Though additional taxes are difficult to implement in the current income-constrained environment, increasing support for a basic income grant highlights pressure on government to adopt a formal stance.
5. **Drawing the line on state-owned enterprise (SoE) funding:** With explicit guarantees adding around 8% to the debt-to-GDP ratio (total contingent liabilities added around 19% of GDP in the previous fiscal year), any additional guarantees or cash injections would add further strain to government's balance sheet.
6. **Government's plan to achieve fiscal sustainability:** Given little room to manoeuvre on the revenue front, the extent to which government digs in its heels to curb expenditure growth will determine how successful it is in stabilising the debt ratio in the next five to 10 years.
7. **Addressing policy uncertainty:** Government's responses on contentious reforms have remained vague, as these issues remain a function of ideological tensions and are likely to elicit a polarised response from within the ruling party's structures. Recent developments on the release of state-owned land and increased dialogue around mobilising pension funds for bankable infrastructure projects have alleviated some of the uncertainty in the areas of land expropriation without compensation and prescribed assets.
8. **Momentum behind structural reforms:** The Economic Recovery Action Plan is a positive stride towards social compacting, but it has not yet been endorsed by Cabinet and risks dilution, in our view.
9. **Implications for SA's sovereign rating:** With no big reformist effort seemingly emerging from government, we believe the bias to SA's sovereign rating outlook is to the downside in the medium term.

1. Post-pandemic nominal growth expectations

The loss in momentum behind growth to 1.2% in the past decade from 3.5% in the previous decade reflects chronic policy uncertainty, stretched government finances, infrastructure constraints and dwindling confidence (see chart 1).

Chart 1: Sentiment remains in the doldrums

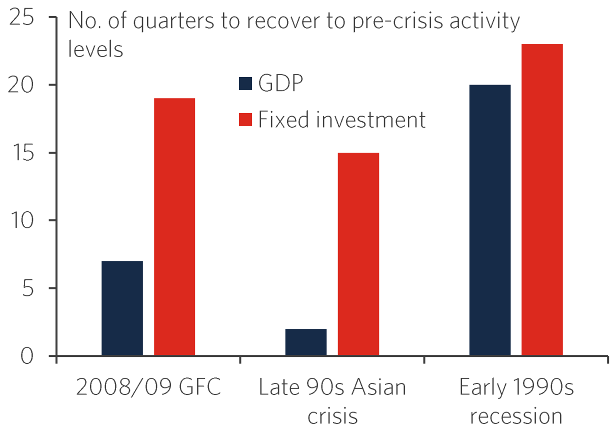


Source: Bureau of Economic Research, Momentum Investments

The growth contribution from fixed investment to overall GDP has waned during the past 10 years, slipping from 19.5% a decade ago to 17.2% in the second quarter of 2020. A reluctance to invest in the SA economy, given concerns about insufficient levels of demand and uncertainty about the political climate, has left growth in private fixed investment at a paltry rate of 0.4% on average for the past 10 years relative to 7.2% in the previous 10-year period (which had included a construction works-related investment boom in the run-up to the 2010 FIFA World Cup). Considering it typically takes fixed investment spending longer than overall GDP to recover to pre-crisis levels (see chart 2), we cannot rely on growth in fixed investment alone to yank the economy out of its growth slump.

Incremental progress on the implementation of economic and regulatory reforms (see section 8) should see local sentiment levels edge higher from a gloomy base in the coming years, but no quick turnaround is projected in our view until the crisis in confidence can be adequately addressed.

Chart 2: A protracted recovery to pre-crisis levels



Source: BNP Paribas, Momentum Investments

Heightened consumer and business stress in SA has been exacerbated by the seventh most stringent lockdown restrictions in the world and this should keep a lid on growth prospects in the medium term. Moreover, export growth is unlikely to strengthen significantly given that the wind has been taken out of the sails of globalisation by unfavourable trade developments between the United States and China (even before the pandemic) and the souring of the global attitude towards trade interlinkages, thanks to the pandemic and the associated lockdowns which accentuated supply chain dependencies.

We expect real growth in GDP to average negative 0.8% between 2020 and 2023 in comparison to Treasury's June 2020 forecast of negative 0.4%, but these figures are likely to be adjusted lower by Treasury in the upcoming October 2020 medium-term budget, following the high-frequency data releases published since then. Risks to our growth view remain firmly to the downside. Estimates by the Council for Scientific and Industrial Research point to a low energy availability factor well into 2022, indicating a high risk of load shedding.

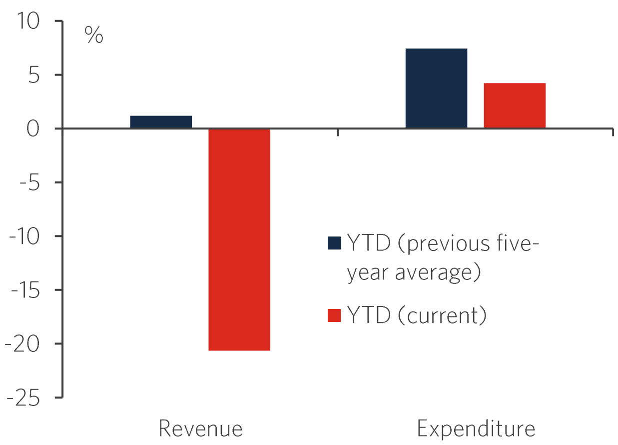
Diminished demand-pull inflation pressure and a muted pass-through from past depreciation in the local currency should see headline inflation averaging 4.3% between 2020 and 2023. This estimate is higher than Treasury's October 2019 estimate of 3.9% for the corresponding period, but only a tad higher than Treasury's expectation for GDP inflation in the same period.

We are broadly in line with Treasury's forecasts using these real GDP growth and inflation forecasts to proxy the outcome of the nominal GDP deflator. In our opinion, the depressed growth environment necessitates a considerable focus on expenditure cuts in non-critical areas of the budget and a shrinking of tax evasion and fraud as well as a recovery in tax morality on the revenue side.

2. Tax collection in a fragile growth environment

The standstill in economic activity, triggered by the lockdown restrictions, had a detrimental effect on government revenue, which has disappointed on a fiscal year to date (YTD) basis relative to the average for the past five years (see chart 3). Meanwhile, expenditure trends were only slightly weaker as government embarked on a countercyclical fiscal approach to prop up economic growth through government spending.

Chart 3: Growth in government revenue and expenditure compared to past averages



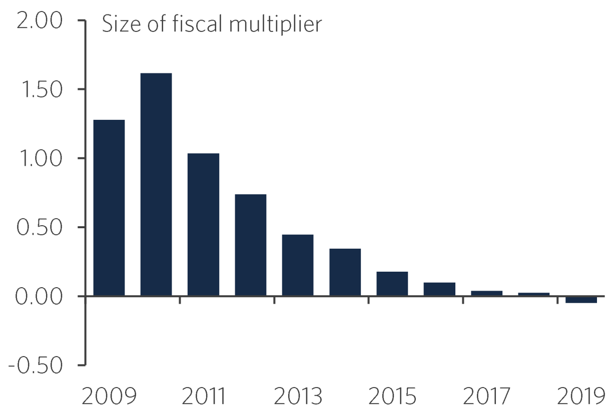
Source: Global Insight, Treasury, Momentum Investments

At a YTD growth rate of negative 20.6%, total tax revenue is lagging the past five-year average of 1.2% but is only marginally lower than the negative 18.3% projected by Treasury in the June 2020 Supplementary Budget. Meanwhile, total government expenditure is growing at a YTD average of 4.2% in comparison to the past five-year average of 7.4% and government's June 2020 estimate of 7%.

SA had the sixth largest fiscal stimulus response to the pandemic from its emerging market (EM) peer group (see chart 4) and second largest monetary stimulus (in the way of policy rate cuts), but the country still suffered the third worst contraction in growth in the second quarter of the year in comparison to the peer group. This is suggestive of reduced effectiveness of the country's stimulus response.

In its Monetary Policy Review for October 2020, the SA Reserve Bank (Sarb) highlighted low and falling fiscal multipliers (change in GDP from a change in government expenditure). "If government spending is paid for with higher taxes, multipliers will tend to be low. Funding through debt can support a higher multiplier where debt is perceived as sustainable. Where sustainability is in doubt, more debt will tend to reduce capital inflows, raise interest rates for the entire economy, and undermine confidence in the economic outlook, thereby lowering the multiplier."

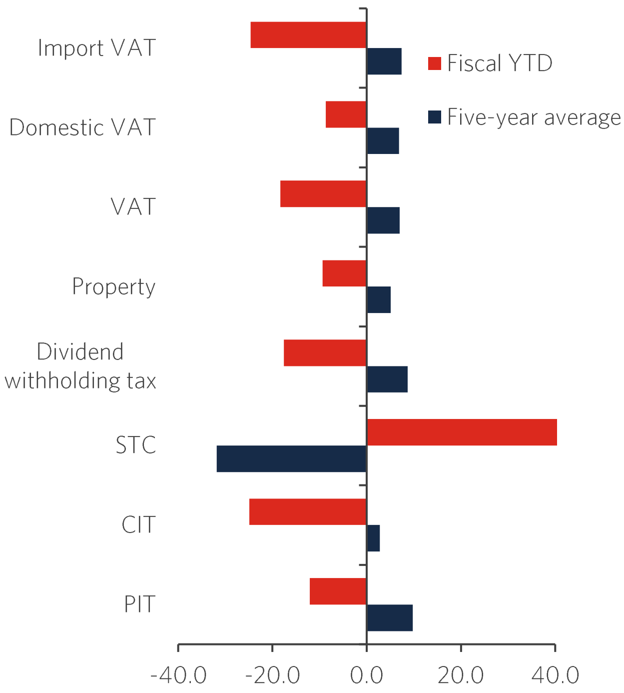
Chart 4: Falling fiscal multiplier



Source: Sarb, Momentum Investments

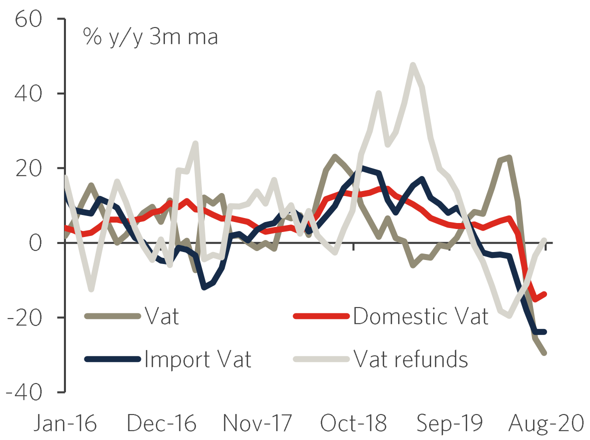
The underperformance in revenue has been largely broad-based (see chart 5), however momentum appears to be recovering in corporate income tax (CIT) and value-added tax (Vat), see chart 6. According to Sars, the hardest hit sectors contributing to CIT included finance and manufacturing, which were negatively affected by load shedding, depressed confidence and heightened uncertainty. On the other hand, personal income tax (PIT) collections continue to struggle against the backdrop of accelerated job losses and deep pay cuts.

Chart 5: Growth in government revenue compared to past averages



Source: Global Insight, Treasury, Momentum Investments, STC = secondary tax on companies at 89.6% fiscal YTD

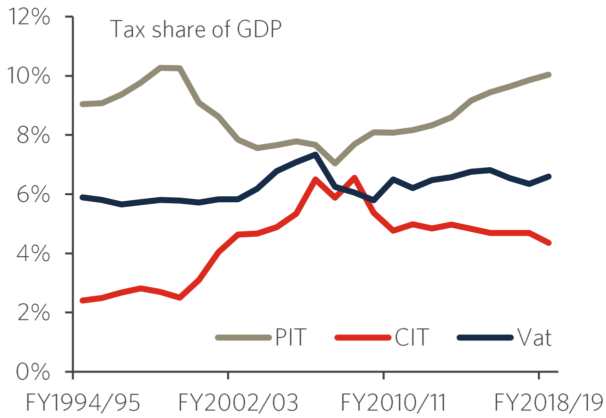
Chart 6: Decline in growth in Vat collections showing signs of bottoming out



Source: Global Insight, Treasury, Momentum Investments

PIT reached 10% of GDP in fiscal year (FY) 2018/19, reaching levels last seen in FY1998/99 (see chart 7). This is despite country-wide wage trends having dipped.

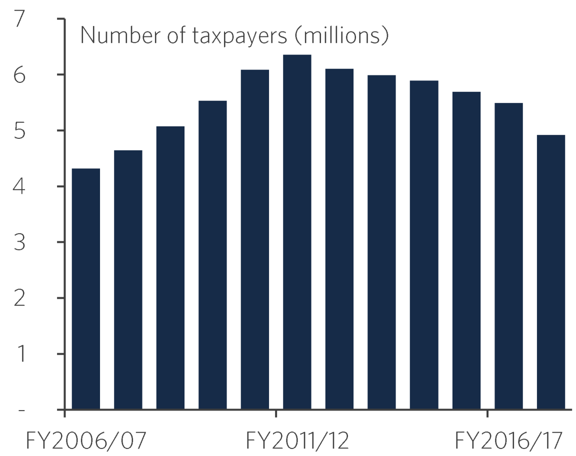
Chart 7: PIT share nearly back at 1999 peak



Source: Global Insight, Treasury, Momentum Investments

Moreover, despite an increase in the number of registered taxpayers to 21.1 million in FY2017/18, the number of assessed taxpayers has dropped to 4.9 million, highlighting a narrowing in the tax base (see chart 8). According to Sars Commissioner, Edward Kieswetter, and BusinessTech, Sars tax direct directives for retrenchments in FY2019/20 had totalled 287 000 from 239 000 in FY2018/19. This points to fewer pay-as-you-earn contributors and more broadly signals further erosion of the tax base.

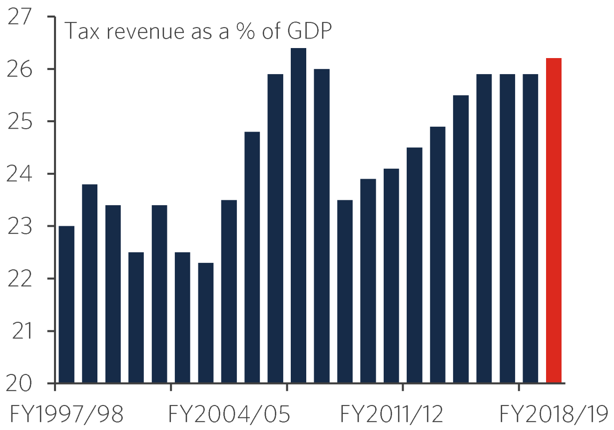
Chart 8: An eroding tax base



Source: Sars, Momentum Investments, data up to FY2017/18

Given the poor state of the economy and SA's already high tax burden (see chart 9), it is unlikely that government will hint at any new tax hikes above what was already announced in the June 2020 Supplementary Budget (R5 billion in FY 2021/22, R10 billion in FY22/23 and R15 billion in FY23/24), in our view.

Chart 9: Tax-to-GDP ratio close to peak

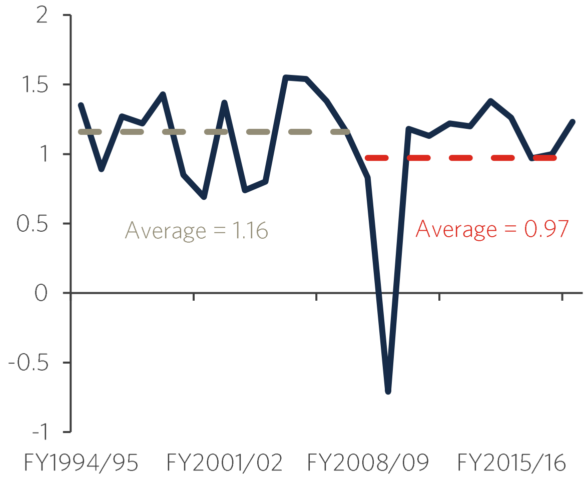


Source: Sars, Momentum Investments

Treasury will likely give us an update on its expectations for the tax buoyancy ratio which is currently tracking above one (i.e. indicating slightly more tax revenue per unit of GDP), unlike the average observed since the global financial crisis (see chart 10).

In July 2020, Treasury noted it was considering the recommendations of the Davis Tax Committee (DTC) for a wealth tax, particularly with its links to estate duties and land taxes. We do not see this as a significant source of revenue, but it may be used, in our opinion, to pave the way for more broad-based taxes to fund rising social needs.

Chart 10: Tax buoyancy ratio



Source: Sars, Momentum Investments, data up to FY2018/19

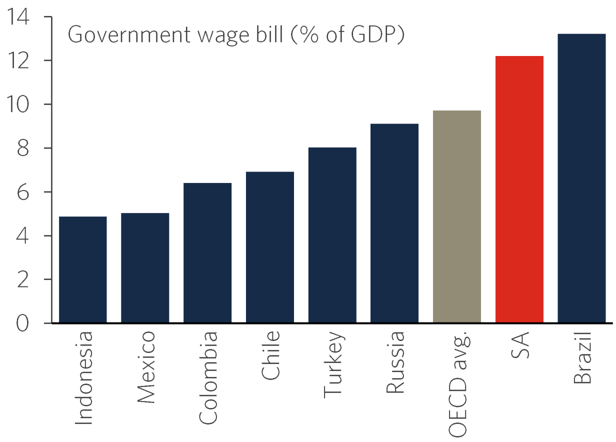
An additional once-off source of revenue may result from the auctioning of high-demand spectrum. The spectrum auction which was originally scheduled for December 2020 has been pushed out to March 2021 due to outstanding matters related to the viability of the Wireless Open Access Network. TechCentral projects government could raise around R12 billion through the auction. This is only likely to be recognised in FY2021/22.

3. Developments in the ongoing public sector wage dispute

The OECD has suggested that SA's wage bill, at 12% of GDP, is one of the highest among OECD and partner countries (see chart 11). An exorbitant average increase of 11% per year for the past decade has seen government wages grow to 38% of consolidated government spending in 2019.

According to the OECD, the number of employees only increased by 100 000 in the past decade, leaving wage increases as the main culprit behind the burgeoning wage bill in SA. Public employment as a share of total employment in SA ranked relatively close to the OECD average in 2017.

Chart 11: Outsized government wage bill



Source: OECD, Momentum Investments

Promotion policies have also been to blame. In FY2006/07, 10% of the public sector workforce were employed in the higher job grades (level nine to 16), but by 2017, this share had grown to 21%. The OECD showed that top managers in SA's civil service earn average revenue of nine times the per capita GDP, which is far higher than the six times recorded for the OECD average.

Government has not paid workers their increase in salary for the current fiscal year (between 4.3% and 5.4% depending on their employment level and take-home pay) that had been previously negotiated in the multi-year wage agreement commencing in 2018. These increases would cost government R37.8 billion and can no longer be afforded due to the effect of COVID-19 on government's finances. Government more ambitiously aims to reduce the public sector wage bill for the next three years by R160 billion.

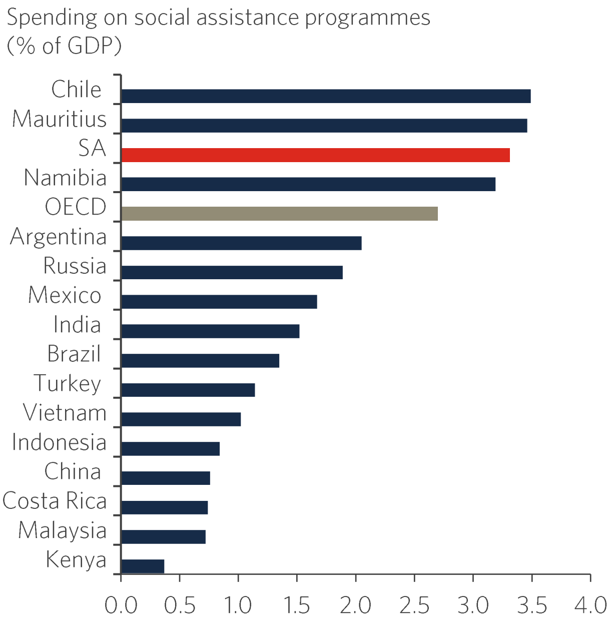
It is unlikely that an agreement will be reached in time in our view to change the wage bill estimates that were presented in the June 2020 Supplementary Budget. Nevertheless, efforts to stick to its proposed cuts will elevate Treasury's credibility in our opinion.

Although this would be a significant step towards fiscal consolidation, we acknowledge the negative effect it would have on household disposable income and as such do not see a significant recovery in household spend in the near term, particularly as growth in jobs remains weak and as banks maintain a cautious stance on lending.

4. Ability to supplement pro-poor spending

Government has maintained a redistributive policy stance despite slowing revenues and tighter fiscal space. More than two thirds (68%) of government expenditure is allocated to education, health, social grants, basic services and other social objectives. In comparison to OECD countries, SA's social programme is one of the largest in relation to GDP (see chart 12).

Chart 12: Government policy is highly redistributive



Source: OECD, Momentum Investments

In response to the COVID-19 crisis, government extended social assistance by:

- Topping up all social grants between R250 and R300 for six months (child support recipients received an additional R500) between May and October 2020
- Introducing a temporary caregiver grant of R500 a month between May and October 2020
- Introducing a Social Relief of Distress grant of R350 a month between May and October 2020
- Disseminating a million food parcels

With the lockdown restrictions negatively affecting numerous households, calls for a basic income grant have been revived.

The OECD pointed out that cash transfers (handed out to more than 18 million in SA) contribute more than 70% of the income for the poorest 20% of SA's population. The OECD believes the redistributive nature of these cash transfers has helped to alleviate poverty and has reduced the share of the population with 60% or less than the median disposable income from 45% to 32%.

Human rights group, Black Sash, has argued for a phased-in approach for basic income support, first prioritising those in the age groups between 18 and 24 and those between 50 and 59. According to BusinessTech, a discussion paper by the ruling party calculated a monthly grant of R500, for those aged 19 to 59 who are not eligible for any other aid, would cost the state R197.8 billion a year. The paper proposed 50% to 60% could be recouped through additional taxes on the employed.

Near-term pressure on SA's tax base, arising from retrenchments, lower bonus payments and reduced wage increases, suggest these additional taxes will be difficult to implement at the February 2021 National Budget, but increasing support for a basic income grant suggests further discussions will be held in this regard, particularly as government has not released an official stance on this as yet.

5. Drawing the line on SoE funding

SoEs play a crucial role in SA's economy. The OECD found that SA has one of the highest public ownership of firms (see chart 13) and this influences the competitiveness of intermediate goods. Given the operational and financial underperformance of many of these public entities, this has had a negative consequence for the cost of doing business in SA.

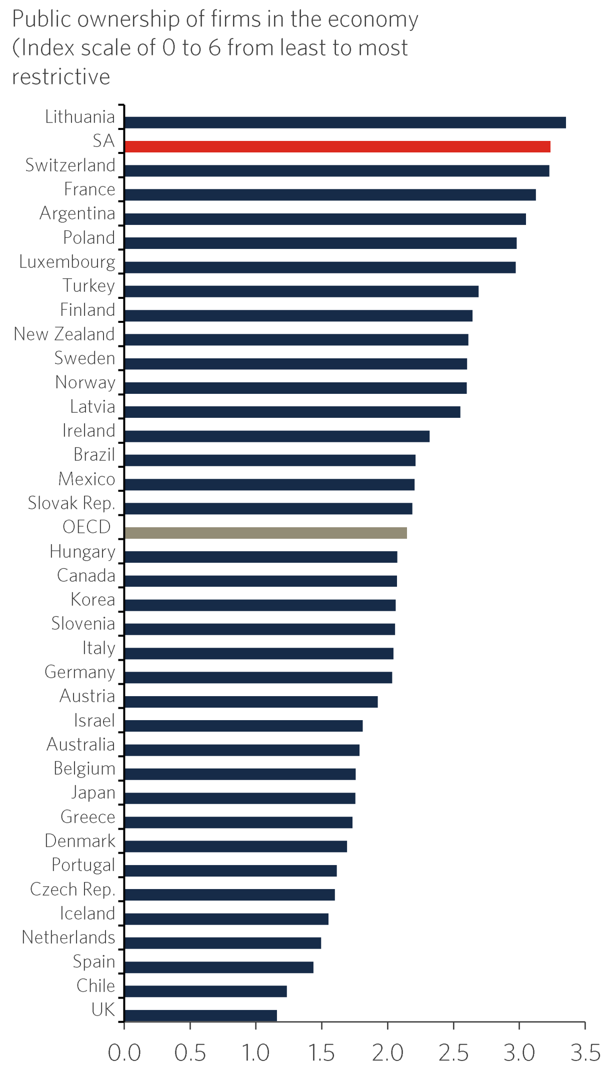
The COVID-19 pandemic has in addition led to a number of finance-constrained SoEs requesting further aid from government. They include:

- R4.9 billion for the SA Post Office
- R1.5 billion for the SA Broadcasting Commission
- R3.5 billion for Airports Company SA
- An undisclosed amount for Denel to pay salaries and complete projects for the SA National Defence Force after the entity recorded a loss of R1.7 billion
- An additional R10.5 billion for the rescue plan of SA Airways (its 2019 financials reflected a loss of R5 billion) for the airline to resume operations

At last reporting, Eskom had projected a R20 billion loss for financial year 2020. Even after receiving R133 billion in government support since 2008 (and expected to receive R112 billion in the next three years), the electricity utility's debt burden sits at R454 billion.

In the Letter of Intent drafted to the International Monetary Fund in lieu of the Rapid Financing Instrument facility, Treasury and the Sarb suggested transfers to SoEs would be rationalised and these SoEs would in turn have to meet key performance indicators.

Chart 13: SoEs' grasp on the economy is high



Source: OECD, Momentum Investments

With explicit guarantees adding around 8% to the debt-to-GDP ratio (total contingent liabilities added about 19% of GDP in FY2019/20), any additional guarantees or cash injections would add further strain to government's balance sheet.

6. Government's plan to achieve fiscal sustainability

Treasury presented two debt scenarios in June 2020. In the passive scenario, it is assumed government takes no action in response to weaker growth and higher spending relative to the February 2020 National Budget. Debt would exceed 100% of GDP by 2022 and would spiral rapidly from there. In the active scenario, government employs significant expenditure cuts to reduce the budget deficit from 2021 onwards, allowing debt to peak at 87% of GDP in 2023.

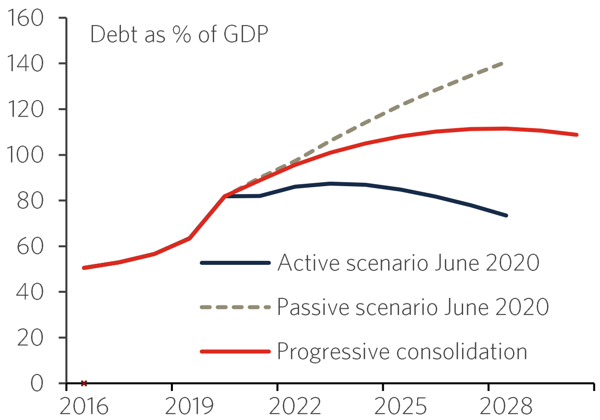
The OECD has sketched a third scenario, the progressive scenario, in which growth recovers to 2% by 2025 and fiscal consolidation, to the order of 1% of GDP, occurs each year until 2030 (see chart 14).

Given little room to manoeuvre on the revenue front, the extent to which government digs in its heels to curb expenditure growth will determine how successful it is in achieving stabilisation in the debt ratio in the next five to 10 years.

Treasury alluded to a zero-based budgeting approach and made mention of a debt ceiling. It is likely to reinforce these concepts at the upcoming medium-term budget and any progress in this regard would be viewed as a positive.

According to JP Morgan, SA has acquired loans from the IMF (US$4.3 billion), the National Development Bank (US$1 billion) and the African Development Bank (US$0.3 billion), which account for about R95 billion. JP Morgan notes that with a possible US$1.5 billion in Eurobond issuance for this fiscal year, the budgeted foreign loan requirements could mostly be met without the need for the World Bank loan of US$2 billion.

Chart 14: Debt ratio scenarios



Source: Treasury, OECD, Momentum Investments

7. Addressing policy uncertainty

Government's responses on contentious reforms have remained vague, as these issues are a function of ideological tensions and are likely to elicit a polarised response from within the ruling party's structures.

Land expropriation without compensation

At the start of October 2020, the Minister of Agriculture, Land Reform and Rural Development, Thoko Didiza, announced government's plans to distribute 700 000 hectares (896 farms) of underutilised or vacant state-owned farming land in seven provinces. Women, people with disabilities and those with prior experience in farming will be given preference and will have to undergo a basic compulsory training programme on basic financial management, record keeping and enterprise development. The minister noted the leases would not be transferable. SBG Securities noted the amount of land is significant and equates to around 8% of the land that was distributed between 1994 and 2018. As such, this move should take some of the pressure off the debate on land expropriation without compensation.

In respect of land reform, the president previously acknowledged the need for a clear property rights regime to encourage higher economic growth.

While shorter-term efforts will likely be concentrated on developing publicly owned land, in the long term ensuring a rollout of land expropriation without compensation, in a way that increases agricultural production and food security, would be viewed as market friendly.

The main concern regarding the distribution of the 700 000 hectares of land is that beneficiaries will be given a 30-year leasehold with an option to buy. As such, beneficiaries do not have full title or direct ownership and accessing capital could be onerous.

National Health Insurance (NHI)

The health ministry reiterated that the pandemic has merely highlighted the importance of the NHI given the shortcomings of the current healthcare system. Government looting through the emergency procurement programme in the COVID-19 crisis highlights concerns over the management of a universal healthcare system, while stretched government finances raise concerns on the source of financing.

In March 2017, the DTC calculated that at an average growth rate of 2%, the NHI scheme would hit a shortfall of R108 billion by 2025, even with financing of R265 billion a year. The DTC proposed a tax rate scenario of a 2% increase in payroll on employers, a 2% surcharge on taxable income and a 2.5% increase in Vat to fund the R108 billion shortfall. These estimates were, however, based off 2010 pricing.

Prescribed assets

Strong opposition by investors to instruct retirement funds on how to fund social development has led to the discussion on easing the barriers to infrastructure investment by providing a pipeline of bankable projects. Government aims to find ways to unlock SA's pension funds to assist with the country's infrastructure goals.

The Investment and Infrastructure Office quoted a study by RisCura that only 2.3% of pension assets are allocated to private equity in SA, while the global average is 24.8%. It believes there is interest, however the lack of activity in SA has meant that 83% of private equity funds are allocated outside of SA. In response, government has gazetted R340 billion (50 projects) in bankable projects. These projects are expected to create more than half a million jobs. Government recognises that the low level of public-private partnerships (PPPs) at 2% of total investment in public infrastructure can be attributed to complex, lengthy and costly procedures and it is aiming to ensure a smoother path between inception and execution.

Regulation 28 of the Pensions Fund Act, as it stands, permits retirement funds to invest up to 35% in unlisted assets with caps on private and unlisted equity. The Association for Savings and Investment SA (Asisa) has taken the stance Regulation 28 sets investment limits and amendments to these limits do not equate to prescription. But, it is also of the view that the current Regulation 28 provisions do not prevent increased investment in infrastructure. Government's economic cluster believes that Regulation 28 may be too restrictive to facilitate infrastructure investment. Nevertheless, it states that "we are moving to an environment where there is no enforced prescription, but you create an environment where trustees can invest in infrastructure profits as long as these projects are profitable".

Sovereign wealth fund, a state bank and the nationalisation of the Sarb

Dire economic growth outcomes are realistically expected to quash any meaningful movement on nationalisation talks in the short to medium term, in our view.

8. Momentum behind structural reforms

An Economic Recovery Action Plan has been negotiated by the National Economic and Development Council (Nedlac), which houses representatives from business, labour, civil society and government. This plan is a positive stride towards social compacting and helps to redirect the radical narrative attached to transforming the economy.

The plan takes a hard line against corruption and does not look at short-term goals at the expense of longer-term imperatives. The Nedlac plan also proposes that a Working Committee meet at least every two months to share reports from each social partner on the implementation of its commitments to the plan.

Efforts have been focused on accelerating progress in the following areas:

- Improving efficiency at ports
- Speeding up the release of a high-demand spectrum
- Stabilising finances and operations at Eskom
- Developing an exploration strategy in the mining sector
- Accelerating the announcement of bid window five of the renewable energy independent power producer programme
- Finalising a Section 34 determination to cater for procurement in excess of 11 gigawatts
- Proposing to ban public servants and politically exposed persons from doing business with the state
- Proposing that all government procurement transactions be transparent

It is important to note that the Nedlac plan has not yet been endorsed by Cabinet and risks dilution. Moreover, SBG Securities warns there are weaknesses in Cabinet positions that are critical to the success of the Nedlac plan.

9. Implications for SA's sovereign rating

With no big reformist effort seemingly emerging from government, we believe the bias to SA's sovereign rating outlook is to the downside in the medium term. Significant fiscal consolidation will be difficult without having a more detrimental effect on growth and employment, in our opinion.

With Standard and Poor's Global Ratings (S&P) having the most bearish ranking on SA's sovereign rating from the three main rating agencies (see table 1), the rating likely captures a slow growth recovery, measured fiscal consolidation and only incremental progress on reforms. At this stage, SA still boasts stronger governance than many single-B rated economies and still houses monetary flexibility and a solid, independent central bank. SA also has deeper domestic markets than the typical single-B rated economy and still has various checks and balances in place, on a relative basis. Lower external leverage further supports the country's BB-rating.

S&P has warned a bigger-than-expected underperformance in growth in SA (leading to greater fiscal challenges), the fiscal drain from SoEs, a loss of property rights and the danger of outright prescribed assets pose the largest threats to SA's sovereign rating.

With S&P's outlook on stable, there is a risk that the agency may lower the outlook to negative at the November 2020 ratings review. However, we are not expecting a lowering of the rating in 2020.

Moody's rating agency views SA's sizeable domestic savings as a policy buffer in SA and ranks the country's low reliance on foreign-currency debt as a positive. Nonetheless, for the 19 largest EMs that Moody's covers, SA and Brazil are expected to undergo the most significant deterioration in their debt-to-GDP ratios by the end of 2021. While a wider primary deficit adds to SA's growing debt burden, interest payments are also one of the highest as a share of revenue from the peer group. Moreover, Moody's noted that within the 19 largest EMs covered, SA and Mexico's contingent liabilities pose a medium-term challenge to their respective government's finances. Although Moody's factors in modest support to SA's weak SoEs, it still notes the risk of widening fiscal deficits arising from larger-than-anticipated financial support.

For SA's debt burden to stabilise by FY2022/23 at higher post-pandemic levels, Moody's points out that SA and Chile will face the largest growth shortfalls of between 4% (SA) and 6% (Chile). Moreover, their primary fiscal gaps need to close between 3% (Chile) and 6% (SA) to stabilise debt (at higher post-pandemic levels). These are the largest adjustments required among the peer group of 19 EMs.

In our opinion, while Moody's may retain its rating following the October 2020 medium-term budget, the risks to a downgrade (particularly for the foreign currency rating) remains high in 2021 as the consensus-building nature of the incumbent administration and the incremental pace of structural reform do not indicate that SA is firmly on the path to strong reform efforts to instil significantly higher levels of confidence and credibility to meaningfully kick-start growth.

Table 1: Sovereign rating matrix

Long-term rating	S&P (30 April 2020)	Fitch (3 April 2020)	Moody's (27 March 2020)
Investment grade (IG)	A-	A-	A3
	BBB+	BBB+	Baa1
	BBB	BBB	Baa2
	BBB-	BBB-	Baa3
Sub-IG	BB+	BB+	Ba1
	BB	BB	Ba2
	BB-	BB-	Ba3
Outlook	Stable	Negative	Negative

Local currency rating
Foreign currency rating
Both ratings

Source: S&P, Moody's, Fitch, Momentum Investments