ANNEXURES

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A

Fiscal risk statement

Introduction

This statement sets out the main fiscal risks to the public finances over the three-year period covered by the *Medium Term Budget Policy Statement*. It also assesses some longer-term risks.

The materialisation of fiscal risks may cause budget outcomes to diverge from expectations or forecasts. This can lead to additional government obligations, expanded public debt, refinancing difficulties or more serious fiscal events. Fiscal risks remain elevated over the medium term. The biggest risks are weaker-than-expected economic performance and associated revenue shortfalls, the poor financial condition of major state-owned companies, and growing financial concerns within subnational government.

This statement categorises fiscal risks in the four areas shown in Figure A.1.

Figure A.1 Fiscal risks framework

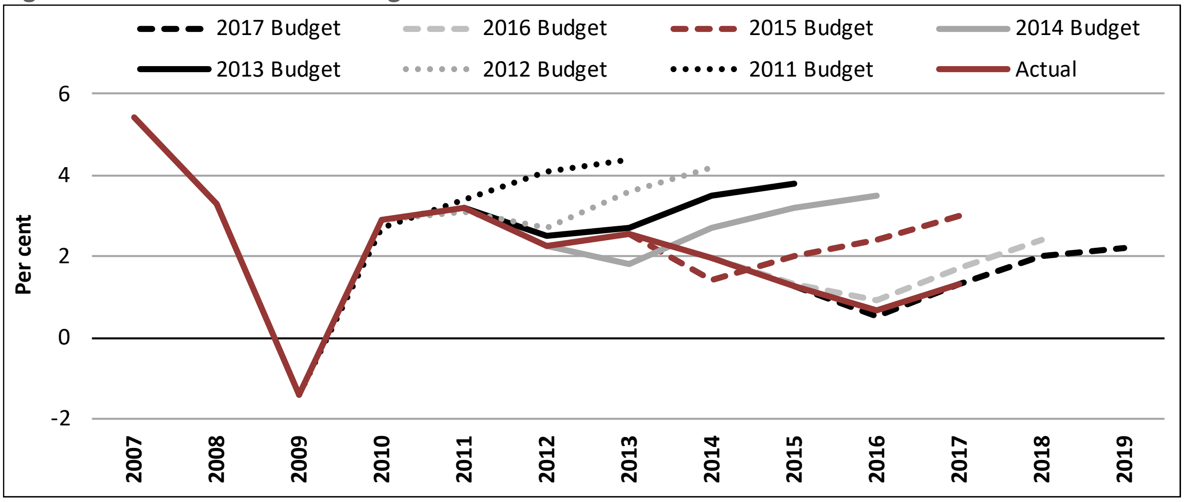
Risk category	Major issues considered under each subtopic
Macroeconomic risks	▪ Effects of slower-than-expected nominal GDP and revenue growth ▪ Debt sustainability under different economic scenarios ▪ Sensitivity of debt and debt-servicing costs to a change in macroeconomic assumptions
Subnational government	▪ Unpaid bills and accruals within provincial and local governments ▪ Failure of municipalities to fully fund operational budgets ▪ Contingent liability risks faced by provincial health departments
Contingent and accrued liabilities	▪ Quality and quantity of state-owned companies' guarantee exposures ▪ State-owned company debt obligations
Long-term economic and fiscal risks	▪ Low long-run economic growth potential without reforms ▪ Effects of demographic changes on expenditure planning

Macroeconomic risks

Figure A.2 shows that over the past six budget cycles, government has overestimated GDP growth in its forecasts. Weaker growth outcomes resulted in unanticipated revenue shortfalls and partly explained increases in government's debt-to-GDP ratio. The deviations are not unique to the National Treasury, and reflect both domestic risks that materialised and technical revisions to historical growth outcomes.

As economic growth projections have been revised down over time, the gap between forecasts and growth outcomes has decreased, reducing (but not eliminating) the risk of a large, unanticipated variance between forecasts and outcomes.

Figure A.2 Revisions to real GDP growth forecast



Source: National Treasury

The National Treasury has produced three scenarios around the medium-term baseline economic forecast to quantify macroeconomic and fiscal risks, and to test the resilience of the fiscal position to unforeseen economic developments. The scenarios are as follows:

Scenario A – Sluggish domestic growth. Confidence and economic activity are slow to recover. Trade tensions increase and monetary policy tightens in developed economies. Global GDP grows by half a percentage point less than forecast. A higher risk premium reflects increased risk aversion among domestic and foreign investors. Commodity prices are lower in response to subdued global demand, but oil prices remain elevated. Interest rates increase to offset inflationary pressures from a weaker rand and bond yields rise, causing higher borrowing costs. As a result, export growth slows and investment declines. GDP grows by 0.9 per cent in 2019 compared with a projected 1.7 per cent in the baseline.

Scenario B – Contagion from a developing-economy debt and currency crisis. Global growth is one percentage point lower than forecast and commodity prices are 15 per cent below expectations. Global financial conditions are significantly tighter and risk aversion increases sharply. In developing countries, large capital outflows prompt sharp currency depreciation. South Africa experiences a decline in exports, consumption and investment as the exchange rate depreciates, inflation breaches 7 per cent and long-term bond yields spike by more than two percentage points. GDP growth contracts in 2019 and 2020.

Scenario C – Stronger domestic growth. Domestic confidence continues to improve. Short-term interventions – such as allocating broadband spectrum in a way that reduces costs – boost confidence and new economic activity. Government interventions reduce the risks that state-owned companies pose to the fiscal framework. The risk premium declines; bond yields are nearly one percentage point lower and business confidence is 15 to 25 per cent higher than forecast. The rand strengthens as foreign inflows increase in response to a healthier economic outlook, supported by policy certainty.

GDP growth is on average one percentage point higher than in the baseline and reaches 3.2 per cent in 2024/25.

Assuming that government does not announce large new spending plans, the fiscal results of the scenarios are as follows:

Scenario A widens the primary deficit, meaning that non-interest expenditure will exceed total revenue. The primary deficit peaks at 1.4 per cent in 2020/21 and gradually narrows, while the gross debt-to-GDP ratio climbs to 68 per cent by 2026/27. In this scenario debt-service costs increase from 14 per cent of budget revenue in 2018/19 to 18 per cent by 2026/27.

In **Scenario B**, the primary deficit widens even further, to 3.6 per cent over the medium term, and remains above 3 per cent over the long term. The debt-to-GDP ratio exceeds 80 per cent by 2026/27 and does not stabilise. Debt-service costs reach 24 per cent of budget revenue by 2026/27. Although the conditions in this scenario are milder than the global financial crisis, economic growth and the fiscal position deteriorate more sharply than they did in 2008 and 2009, because the economy and the public finances are much weaker today.

Scenario C causes the primary deficit to narrow gradually over the medium term. By 2021/22, government achieves a primary surplus of 0.5 per cent. In this scenario, debt stabilises at 55.4 per cent of GDP in 2020/21.

Figure A.3 GDP growth scenarios

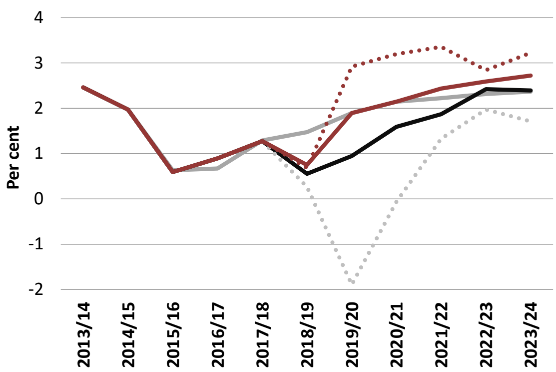
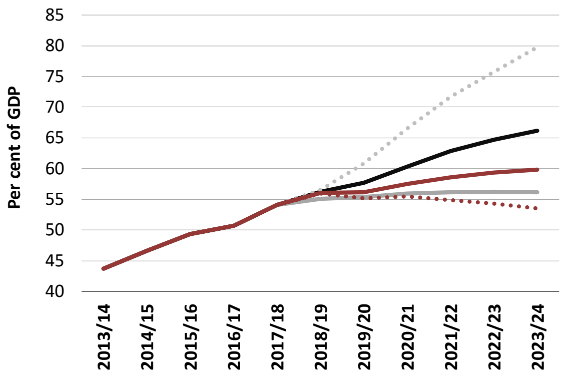


Figure A.4 Gross debt-to-GDP scenarios



Source: National Treasury

The baseline forecast for the 2018 MTBPS shows a small primary deficit over the next three years. If the economic growth forecast set out in Chapter 2 is accurate, and the risks described in this statement do not materialise, the debt-to-GDP ratio should stabilise at 59.6 per cent in 2023/24. As shown in the fiscal scenarios, however, a moderate deviation from these assumptions could result in some fiscal slippage.

Debt management risks

The macroeconomic and fiscal scenarios also consider the risk of higher sovereign debt yields associated with higher risk premiums. Government has a prudent debt management strategy in place that would enable it to manage these risks if they arise.

In both the baseline scenario and Scenario A, South Africa is unlikely to face significant refinancing and rollover risk despite the higher borrowing requirement. This means that government will have sufficient cash to settle obligations as they fall due. With 12.8 per cent of domestic debt maturing in less than 12 months and 90 per cent of gross loan debt denominated in rands, South Africa is unlikely to face a refinancing challenge similar to those experienced by Turkey or Argentina in 2018.

However, non-residents hold 38 per cent of South African foreign and domestic government debt. This relatively high foreign ownership leaves South Africa vulnerable to sudden shifts in investor sentiment. Developments such as deteriorating domestic economic growth or a rapid rise in interest rates in developed economies could accelerate outflows. Table A.1 shows the sensitivity of the debt portfolio to a change in the interest and exchange rate assumptions. Under such conditions, government would still be able to finance its borrowing requirement, but at a greater cost. State-owned companies, however, would likely struggle to refinance existing debt or issue new debt due to the unfavourable outlook for domestic capital markets.

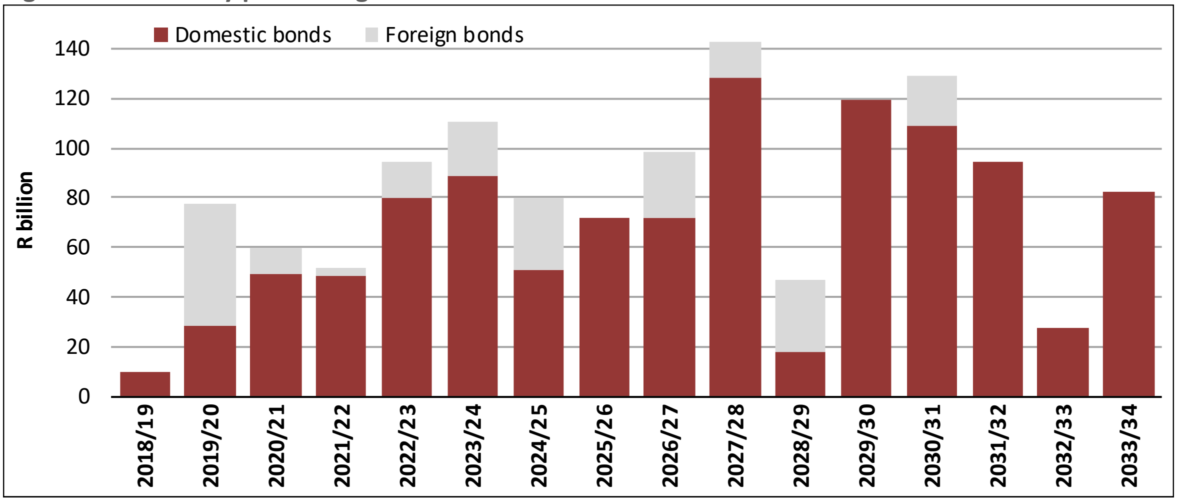
Table A.1 Sensitivity in debt stock and debt-service costs, 2019/20

R billion	Debt-service costs*	Gross loan debt*
Effect of a 10 per cent change in:		
Interest rates	4.1	11.0
Rand/US dollar exchange rate	2.0	28.4
Headline inflation	0.1	3.1

** Sensitivities are positive in the case of a variable rise or currency depreciation and negative in the reverse case*
Source: National Treasury

Redemptions on long-term debt are expected to average R85 billion per year over the next decade. Short-term debt (Treasury bills) maturing in 12 months or less accounts for 12.8 per cent of all domestic debt. This is below the 15 per cent threshold considered prudent for a developing country.

Figure A.5 Maturity profile of government debt



Source: National Treasury, as at 12 October 2018

Subnational government

The growth of unpaid bills and accruals within provincial and local governments constitutes a serious fiscal risk. These hidden costs are not included in the budget. The need to settle outstanding bills may compromise service delivery if, for example, provinces and local government have to use money allocated for basic services to pay outstanding bills.

At the provincial level, unpaid bills are estimated at R25 billion. Although this is a marginal improvement from 2016/17 (R26 billion), it is still a concern given spending pressures within the provinces. Provincial health departments also face contingent liability risks associated with medico-legal claims. In 2017/18 this liability was estimated at R80 billion, up 32 per cent from 2016/17. Pay-outs against these claims amounted to R1.5 billion in 2017/18 and are projected to exceed R2 billion in 2018/19.

In 2018/19, 113 local governments adopted unfunded budgets – an increase from 83 municipalities in 2017/18. In other words, these municipalities made operational spending commitments without identifying revenue sources to fund them. One consequence is that municipalities may not pay service providers. Municipal arrears have grown by an average rate of 35 per cent since 2013/14, and totalled R23.4 billion in 2017/18. About 76 per cent of this amount is owed to other public entities – particularly Eskom and the water boards. A default on these obligations would weaken the public-sector balance sheet.

On a consolidated basis – including national, provincial and local levels – South Africa's public sector has a net asset position of 152 per cent of GDP. According to the International Monetary Fund, which made the calculation, this position is relatively strong. Persistent deficits across the public sector, however, will erode this position and increase fiscal risk.

Contingent and accrued liability risks

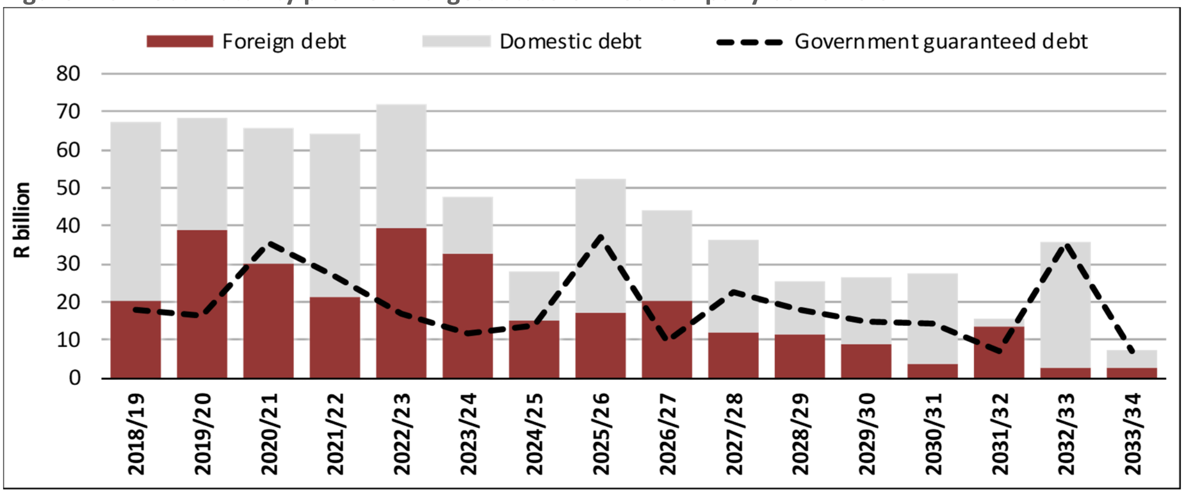
This section describes the risks posed by commitments that may result in future financial obligations (contingent liabilities) and by expenses that have been recorded but not yet paid (accrual liabilities). State-owned companies constitute the vast majority of these risks.

Government's guarantee portfolio totals R670 billion, of which the largest facility has been granted to Eskom (R350 billion). By the end of June 2018, R334.2 billion of government guarantee facilities for state-owned companies had been used. Over the next three financial years, guaranteed debt redemptions are expected to average R26 billion.

In recent years, access to credit has steadily declined for many state-owned companies, mostly as a result of their weak balance sheets, poor corporate governance and liquidity challenges. These entities will find it difficult to refinance maturing debt as investors increasingly require guarantees before they will provide financing. As a result, government's contingent liability exposure is likely to remain high.

In 2016/17, the latest year for which figures are available, the combined liabilities of national public entities and state-owned companies totalled R1.6 trillion. The interest-bearing debt of the 10 state-owned companies that borrow most has grown from R266.7 billion in 2009/10 to R702.7 billion in 2016/17 – an increase of 163 per cent in seven years. This debt is expected to increase to more than R1 trillion over the medium term. Although the increase in debt has largely financed capital expenditure, a growing proportion of debt is now financing operations and interest payments.

Figure A.6 Debt maturity profile of largest state-owned company borrowers*



** Land Bank, DBSA, IDC, Transnet, SANRAL, SAA, TCTA, ACSA, Denel and Eskom*

Source: National Treasury as at 30 June 2018

Debt redemptions for the same 10 companies are expected to average R66 billion from 2019/20 to 2021/22. This amount exceeds government's own debt redemptions over the same period. Large state-owned companies may have to refinance debt at higher interest rates, causing further reductions in profitability and net operational cash, which could in turn affect their ability to service future obligations. Companies unable to refinance debt face the prospect of immediate repayments, which may require them to sell assets or otherwise decrease their operating costs.

Eskom

Eskom has a R350 billion government guarantee facility, of which R255 billion has been used and R35 billion has been approved for specific funding instruments, but not yet borrowed. Eskom's liquidity position has improved compared to the previous financial year on the strength of more positive investor sentiment. As a result, the utility again has access to capital markets. By the end of August 2018, about 73 per cent of Eskom's R72 billion funding requirements for 2018/19 had been secured, with 17 per cent funded for 2019/20. However, Eskom's weak financial position remains a risk that could lead to a call on guarantees. Government continues to work with the utility to strengthen its long-term sustainability.

Denel

Denel has a five-year, R3.4 billion government guarantee, of which R2.8 billion has been used. Denel will struggle to settle maturing debt on its own because its financial position remains weak. While it implements a turnaround plan, Denel will also contemplate the sale of non-core assets to improve its liquidity position.

South African Airways (SAA)

SAA has a R19.1 billion government guarantee, R14.5 billion of which has been used. Debt of R14.2 billion is maturing in or before March 2019. In 2018/19, government is allocating R5 billion to help the airline repay this debt. In general, SAA is not generating sufficient cash to repay its total debt and will have to negotiate with lenders to refinance or extend maturity dates.

Trans-Caledon Tunnel Authority (TCTA)

At the end of June 2018, the TCTA had government guaranteed debt of R18.9 billion. The authority's long-term sustainability is tied to the financial health of the Department of Water and Sanitation's Water Trading Account. Poor financial management at the department continues to threaten the ability of the TCTA to meet its commitments. The department has committed to steps to improve its finances, including working to implement the Auditor-General's recommendations following the 2017/18 audit outcomes.

South African National Roads Agency Limited (SANRAL)

SANRAL has government guarantees of R38.9 billion. There is a risk that this guarantee might be called because the agency is not generating sufficient cash from the Gauteng Freeway Improvement Project to settle redemptions falling due over the MTEF period. To prevent this, government has allocated R5.8 billion to SANRAL in 2018/19.

Road Accident Fund (RAF)

The Fund represents a potentially large liability. The RAF's operational deficit in 2017/18 declined to R26 billion from R35 billion in 2016/17. However, despite a 30c increase to the RAF levy in the 2018 Budget, the fund's liability is expected to grow to R393 billion by 2021/22 from R206 billion at present. The RAF will require further large increases to the fuel levy in each of the next three years to manage the short-term liability.

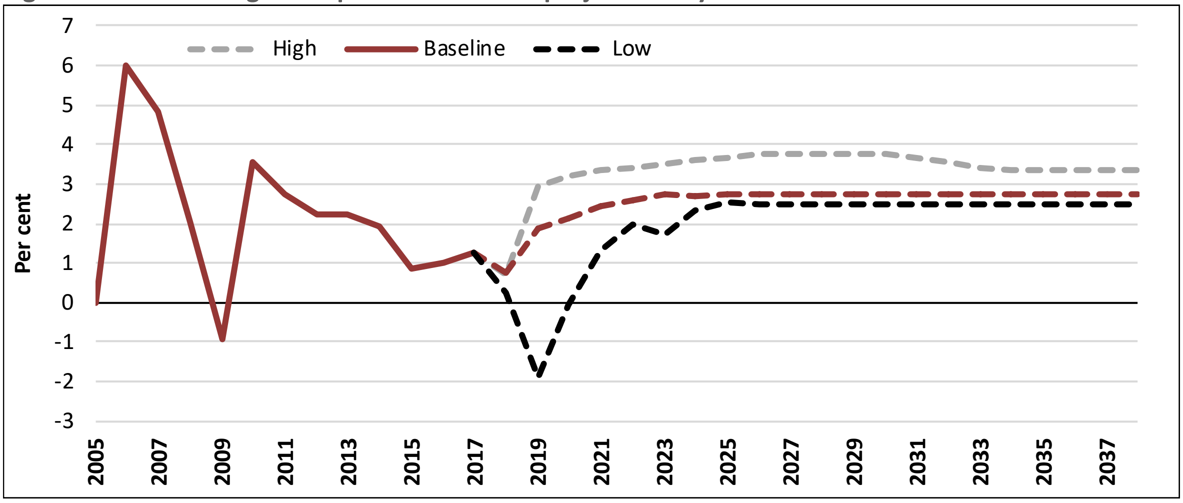
Long-term fiscal risks

The National Treasury regularly updates its long-term fiscal model, which projects economic growth and fiscal sustainability up to 2060 based on a range of variables and scenarios. The model confirms that South Africa's current long-term economic growth potential is relatively low. Without implementing growth-enhancing policies and reforms, real GDP growth is expected to average about 2.6 per cent between 2018 and 2040. Over this period, the population is expected to increase from 57 million to 70 million people.

In the baseline economic scenario, unemployment will remain stubbornly high over the coming decade and growth in per capita income will be stagnant. It is also possible that global and domestic shocks could cause long-term growth to be even lower than the baseline projections. In the pessimistic low-growth scenario, economic growth will average 1.8 per cent between 2018 and 2040. The National Treasury's high-growth scenario assumes long-run growth of 3.3 per cent.

Three scenarios are summarised in Figure A.7 below.

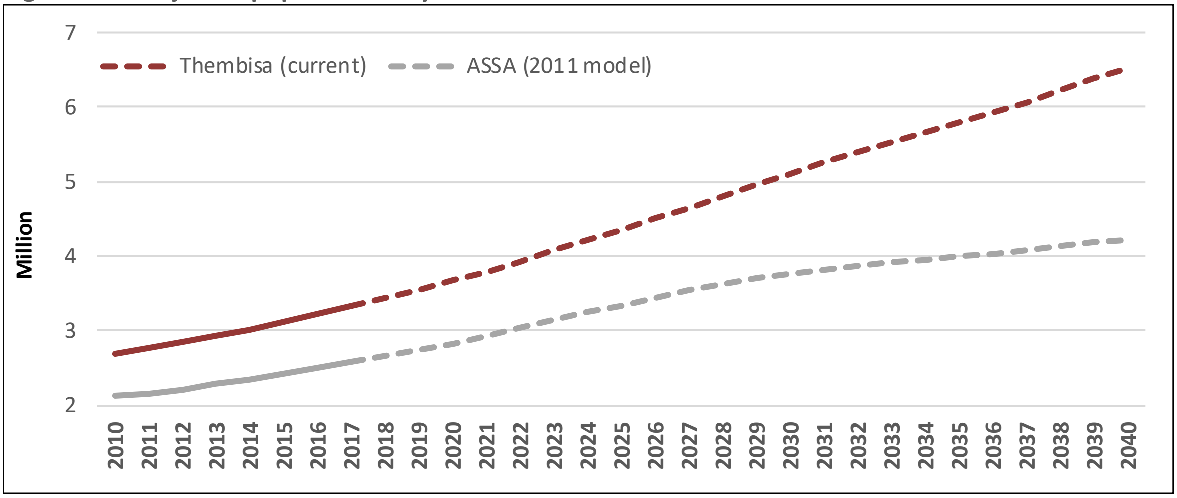
Figure A.7 Real GDP growth performance and projections by scenario



Source: National Treasury

At a minimum, economic growth of 2.5 to 3 per cent is required to sustain current public spending commitments. Recent actuarial analysis from the University of Cape Town, using the Thembisa model, shows that South Africa's population is ageing more rapidly than previously expected due to gradual declines in fertility and mortality rates. Statistics South Africa's most recent mid-year population estimates confirm these declines. In its 2014 report, titled *Census 2011: Profile of Older Persons in South Africa,* Statistics South Africa noted that 40 per cent of elderly people in South Africa are poor. Planning documents such as the NDP Vision 2030 and the National Health Insurance White Paper are based on older actuarial models.

Figure A.8 Projected population 65 years and older*

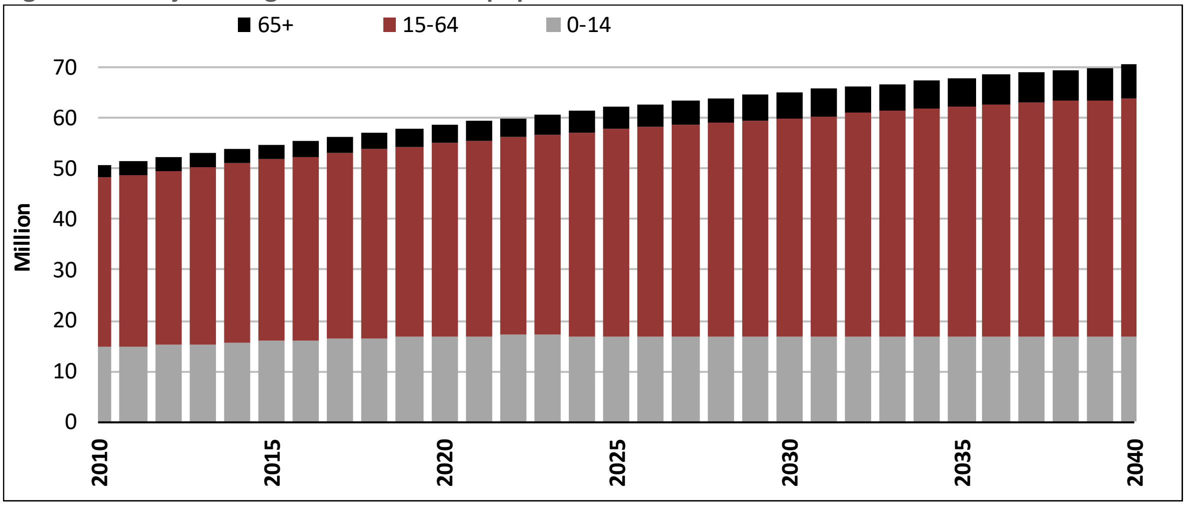


**The Thembisa model includes Census 2011 data released after the ASSA model was developed*

Sources: Thembisa demographic and epidemiological model, ASSA demographic model

Statistics South Africa is currently updating its long-term demographic projections, which are expected to be released in 2019. Planning for basic service delivery, pension and old age grants, and programmes such as social housing will need to take these updated projections into account.

Figure A.9 Projected age structure of the population



Source: Thembisa demographic and epidemiological model

In light of recent policy changes and economic developments, the National Treasury will undertake an extensive review and update of its long-term fiscal model in 2019. The projections will be released by the time of the 2019 MTBPS and will include newly costed spending and sustainability estimates for long-term commitments, such as national health insurance.

Conclusion

While the outlook for fiscal risks has improved marginally over the past year, risks remain elevated over the medium term. Government is working to prevent these risks from materialising – and where that is not possible, to mitigate and manage their consequences.