# ANNEXURES

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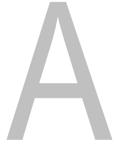


# Fiscal risk statement

## Introduction

This statement sets out the medium- to longer-term risks to the public finances, with shorter-term risks outlined in Chapter 3.

The major fiscal risks are lower potential economic growth, debt management considerations associated with the elevated public-sector borrowing, financial weaknesses in subnational government, and government's large contingent and accrued liabilities.

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

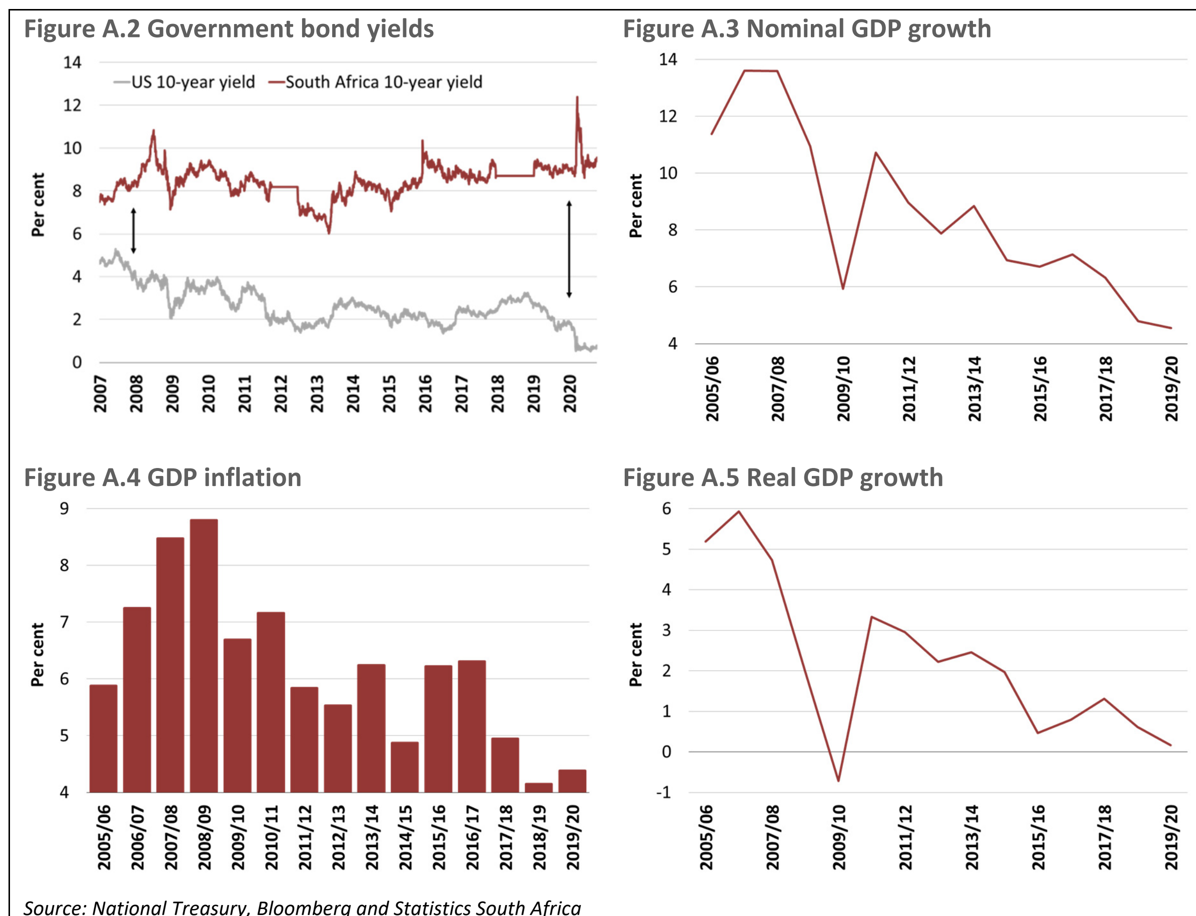
**Figure A.1 Fiscal risk framework**

| Risk category | Major issues considered under each sub-topic |
|---|---|
| Macroeconomic risks | ▪ Lower nominal GDP and revenue growth over the medium term<br>▪ Debt sustainability under different macroeconomic scenarios |
| Debt management risks | ▪ Large debt redemptions falling due over the medium term<br>▪ Growth in debt-service costs<br>▪ Domestic banks' exposure to public-sector debt |
| Subnational government risks | ▪ Medico-legal claims<br>▪ Unpaid provincial invoices<br>▪ Financial condition of municipalities |
| Contingent and accrued liability risks | ▪ State-owned companies' guarantee exposures<br>▪ Public-private partnerships<br>▪ Financial position of the Road Accident Fund |

## Macroeconomic risks

The weakening of South Africa's fiscal position has partly been the result of long-term economic trends. Economic growth has declined on aggregate since the global financial crisis of 2008/09, reflecting structural constraints that limit the economy's ability to grow. This has been exacerbated

by downward revisions to nominal GDP and declining GDP inflation. In 2020, the coronavirus pandemic and the associated lockdown sharply reduced productive capacity and employment, resulting in higher poverty levels. The longer-term implications of the lockdown remain to be seen. A key issue is whether the economic recovery will be strong enough to allow for the full withdrawal of temporary support under the COVID-19 fiscal support measures. Persistently low economic and revenue growth will make it more difficult to achieve the fiscal targets.




*Source: National Treasury, Bloomberg and Statistics South Africa*

Since 2014, the yield on South Africa's long-term debt has trended upwards, while the yield on the United States 10-year Treasury bond has declined. This shows an increase in South Africa's risk premium – the additional amount that government pays to compensate for uncertainty. Should this combination of weaker nominal growth and rising yields persist, it will require consistently higher primary surpluses, where revenue exceeds non-interest expenditure, to stabilise the public finances over the long term.

The National Treasury maintains a long-term fiscal model. It uses the model to cost new policy initiatives and determine the sustainability of current spending commitments, based on assumptions of economic and demographic growth. The results are published every two years. The next update is scheduled for 2021, and the National Treasury will undertake an extensive review of the model, with newly costed spending and sustainability estimates for long-term commitments such as national health insurance.

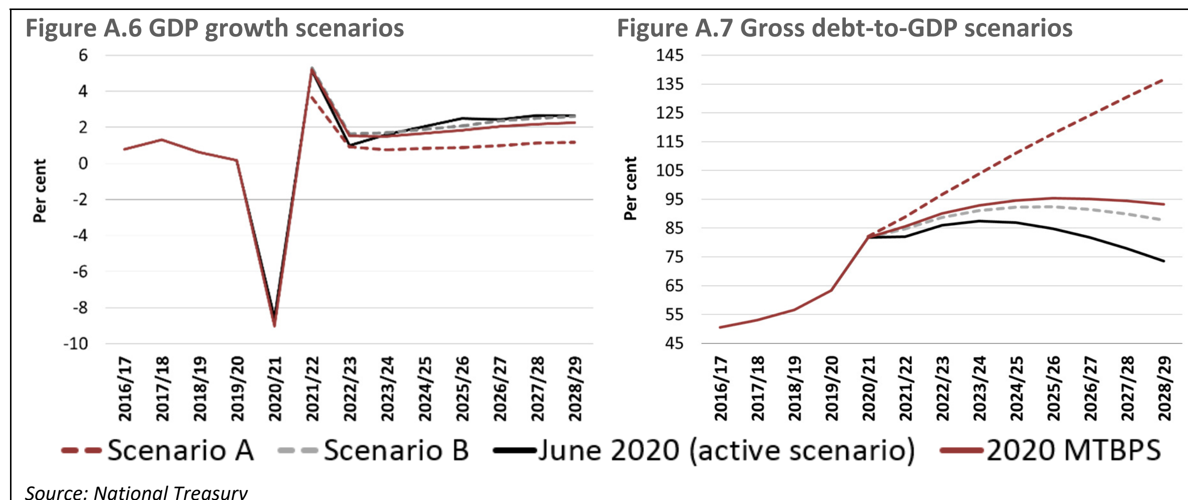
**Fiscal scenarios around the baseline economic forecast**

Chapter 2 presents the National Treasury's baseline economic forecast. Two scenarios have been modelled around this forecast, as set out below. Given the complex nature of long-term modelling, any moderate deviation from the assumptions could result in substantially different outcomes.

**Scenario A** – Spending reductions are not implemented and limited progress is made on structural economic reforms. On average, the primary deficit is 2.4 percentage points of GDP wider than the baseline over the medium term. As a share of revenue, debt-service costs increase from 21.2 per cent in 2020/21 to 35 per cent in 2028/29. The debt-to-GDP ratio does not stabilise.

**Scenario B** – Implementation of economic reforms strengthens domestic growth. The primary balance closes more rapidly than in the baseline forecast. Debt stabilises at 92.4 per cent of GDP in 2025/26.

**Figure A.6 GDP growth scenarios** **Figure A.7 Gross debt-to-GDP scenarios**



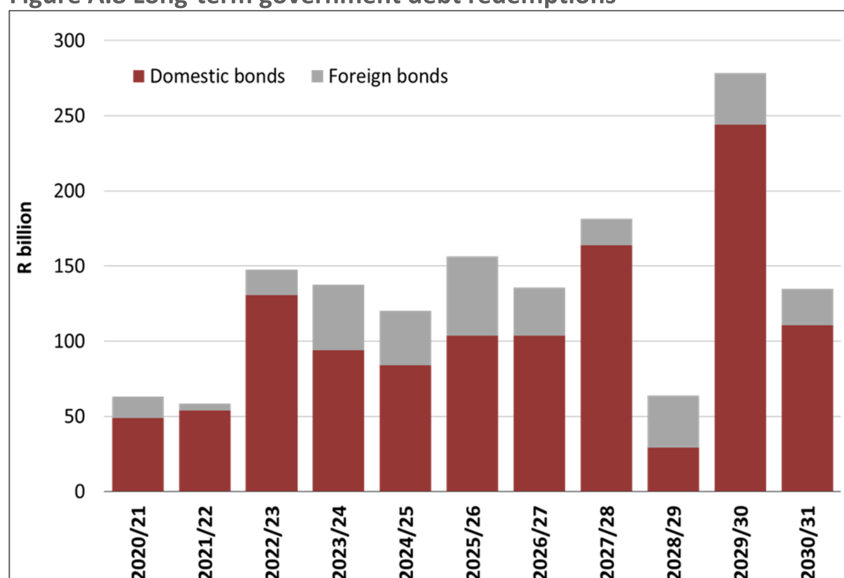

*Source: National Treasury*

## Debt management risks

Government's funding needs will remain elevated for the next several years. Debt levels will become unsustainable without fiscal consolidation. Long-term debt redemptions (Figure A.8) will average about R134.4 billion over the next decade, up from an average of R37.3 billion in the previous 10 years. If additional borrowing is required to finance deviations from fiscal targets, it will result in higher redemptions falling due, creating rollover risks. To mitigate this risk, government will increase its cash balances through borrowing in the domestic and international markets, and continue with the bond-switch programme, which exchanges shorter-dated debt for long-dated debt.

In the current year, government's financing costs have been largely driven by concerns about low growth and fiscal weakness, as reflected in sovereign credit rating downgrades by all major rating agencies. Higher financing costs of net new debt have in turn increased debt and debt-service costs. A peer comparison undertaken by the National Treasury in August 2020 observed that South Africa's ratio of interest payments to GDP is projected to be higher than in countries with similar or weaker credit ratings, such as Morocco, Brazil and Armenia, in 2020 and 2021. Furthermore, the negative outlooks assigned by three of the four rating agencies implies a high likelihood of further downgrades, which would put upward pressure on funding costs. Government will continue mitigating this financing cost risk by issuing bonds with a 10–15 year maturity to lower the cost of funding, while considering the effect on refinancing risk. Ultimately, fiscal consolidation is required to mitigate the risk of higher debt and debt-service costs.

**Figure A.8 Long-term government debt redemptions**




*Source: National Treasury, as at 30 September 2020*

Non-resident holdings of South African bonds have fallen from 37.1 per cent in December 2019 to 29.2 per cent in September 2020, their lowest level since 2011. This decline has been offset by an increase in the bond holdings of domestic banks, which have increased from 16.8 per cent in January 2020 to 22.9 per cent in September 2020. South African banks' exposure to public-sector debt (bonds and loans) grew from R174 billion in 2008 to R811 billion in February 2020. This translates to 15.3 per cent of total banking assets, a 7.7 percentage point increase from a decade earlier.

Table A.1 shows the sensitivity of the debt portfolio to changes in interest-rate, exchange-rate and inflation assumptions. In the case of a 10 per cent increase in any category, government would continue to finance its borrowing requirement, but at greater cost. Similarly, favourable movements in any of these categories would reduce borrowing costs.

**Table A.1 Sensitivity in debt stock and debt-service costs, 2020/21**

| R billion | Debt-service costs | Gross loan debt |
|---|---|---|
| **Effect of a 10 per cent change in:** | | |
| Interest rates | 5.6 | 23.5 |
| Rand/US dollar exchange rate | 2.1 | 49.6 |
| Headline inflation | 0.1 | 3.1 |

*Source: National Treasury*

Funding in an environment of low credit ratings, deteriorating economic conditions and rising debt levels implies a funding strategy of navigating carefully through the trade-offs of reducing the costs, while controlling refinancing risk and managing the impact of currency risk.

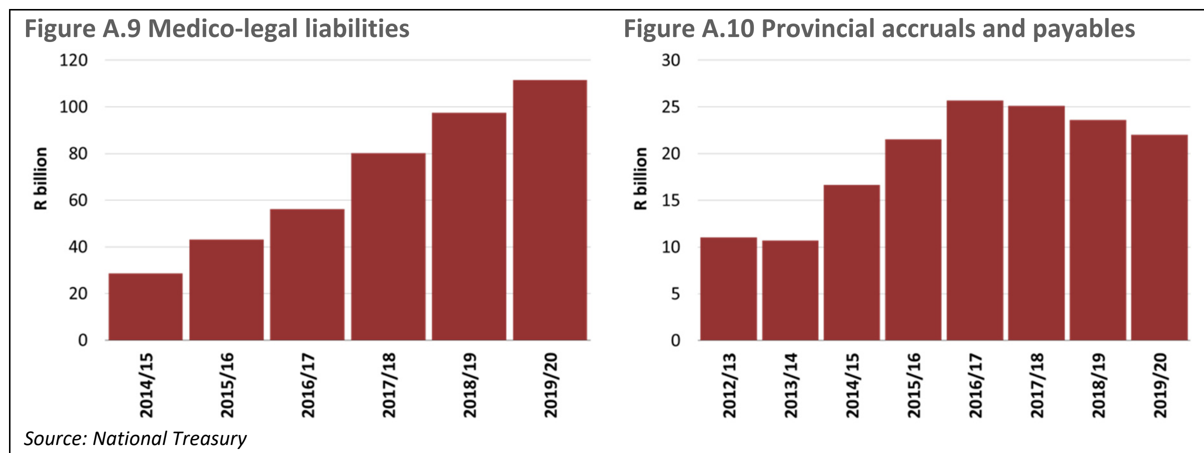
## Subnational government risks

Over the medium term, the primary fiscal risks associated with subnational government relate to medico-legal claims, unpaid provincial invoices and weak financial management in municipalities.

The potential liability from **medico-legal claims** (Figure A.9) increased from R97.4 billion in 2018/19 to R111.5 billion in 2019/20. The highest level of claims (38 per cent) is in the Eastern Cape. Although actual payments declined slightly from R2 billion in 2018/19 to R1.7 billion in 2019/20, this remains a considerable source of pressure on provincial healthcare budgets. The

State Liability Amendment Bill, currently before Parliament, seeks to alleviate the problem by allowing courts to order the public sector to provide rehabilitation services to claimants in kind instead of paying private-sector rates, and allowing for future costs and compensation to be paid periodically instead of as lump sums up front.

**Unpaid provincial invoices** (Figure A.10) declined slightly from R23.9 billion in 2018/19 to R22.2 billion in 2019/20. The implication is that the future provincial budgets will have to pay down accruals before purchasing goods and services. In the worst-affected provinces, goods and services budgets may be insufficient to cater for their service delivery commitments for the entire fiscal year after paying down accruals. In the context of fiscal consolidation weighted towards the wage bill, provinces will have to implement strong measures to ensure that the accruals continue on a downward trend.




*Source: National Treasury*

The **poor financial position of many municipalities** – a consequence of weak financial management – has been exacerbated by COVID-19. At the end of June 2020, uncollected revenues in local government had grown by 16.3 per cent from June 2019 to R171.9 billion. According to the Auditor-General’s 2018/19 report on local government finances, about 47 per cent of municipalities incurred a deficit and total deficits grew from R669 million in 2017/18 to R2.3 billion in 2018/19. This financial weakness has led to a decline in repairs and maintenance spending, which in turn has caused high water and electricity losses. Above-inflation wage increases at local government level will add additional pressure.

The National Treasury and the Department of Cooperative Governance and Traditional Affairs have developed a rigorous monitoring regime to strengthen local government finances.

## Contingent liabilities

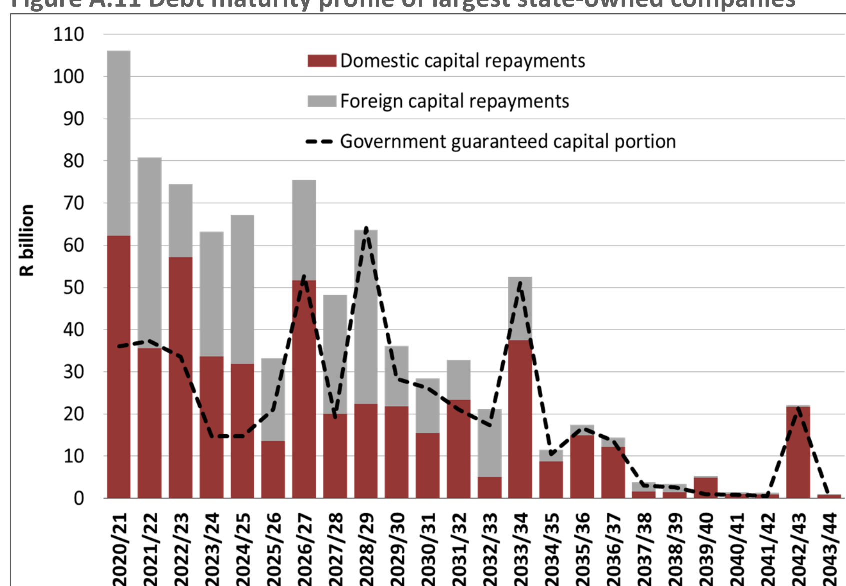
Contingent liabilities are commitments that may result in financial obligations if specific events occur. The majority of contingent liability risk stems from the poor financial condition of South Africa’s major state-owned companies. Some of these risks have already materialised.

By 2022/23, contingent liabilities are expected to exceed R1 trillion. These liabilities consist of government guarantees to state-owned companies, the Renewable Energy Independent Power Producer Programme, public-private partnerships (PPPs), and obligations to the Road Accident Fund and other social security funds. Government’s guarantee portfolio has increased from R680 billion in March 2019 to R693.7 billion in March 2020, of which the largest facility has been granted to Eskom (R350 billion). By end-March 2020, R583.8 billion of these government guarantees had been used. Over the next three fiscal years, guaranteed debt redemptions are expected to average R35.6 billion, up from R27.5 billion reported last year.

The interest-bearing debt of the 10 largest borrowers grew from R266.7 billion in 2009/10 to R795 billion in 2017/18 – an increase of 198 per cent in nine years. The National Treasury estimates that the collective debt of the 10 largest borrowers is likely to exceed R810 billion in 2019/20. In addition, the effective cost of debt for these entities, a broader measure that includes both interest and non-interest costs, rose from 8.7 per cent in 2009/10 to 9.8 per cent in 2017/18. Total debt redemptions are estimated to average R87.1 billion annually over the next three years.

It has become increasingly difficult for state-owned companies to access capital market funding. Capital markets assign high levels of risk to poor financial performance, substandard operating performance, unsustainable debt-service costs and lapses in governance. Rising interest rates and increasingly unfavourable loan terms and conditions raise borrowing costs significantly. Over the past several years, these trends have combined to put additional strain on the public finances, in the form of additional requests for guarantees and recapitalisation. The coronavirus pandemic has exacerbated this trend.

**Figure A.11 Debt maturity profile of largest state-owned companies***




**Airports Company South Africa, Denel, Development Bank of Southern Africa, Eskom, Industrial Development Corporation, Land Bank, South African Airways, South African National Roads Agency Limited, Trans-Caledon Tunnel Authority and Transnet*
*Source: National Treasury as at 31 March 2020*

Government's contingent liabilities include PPP contracts worth R8.7 billion. Although several PPPs experienced revenue losses as a result of the national state of disaster regulations, they did not call on the guarantees. This demonstrates the high-quality PPP approval process that the National Treasury put in place following the 2008 global financial crisis, during which several developed-country governments faced large liabilities from badly designed and undisclosed PPPs. The National Treasury continues to work with the World Bank to enhance risk-sharing and transparency in its PPP approval process.

### State-owned companies

State-owned companies continue to present significant fiscal risks in the form of contingent liabilities and direct requests for state financial support. COVID-19 and associated restrictions on economic activity have increased the financial pressures they face. Changing debt market dynamics and other factors threaten the survival of some companies in their current form. Addressing these matters requires both decisive government action and determined implementation of turnaround plans.

**Airports Company South Africa**

Travel restrictions imposed during the coronavirus pandemic resulted in a sharp decline in air traffic volumes in 2020. Medium-term projections are also expected to be relatively low. As a result, Airports Company South Africa (ACSA) does not have sufficient funds for its operational requirements. To address the shortfall, ACSA has secured short-term bank loans, reduced operational and capital expenditure, and revised its corporate strategy. In addition, ACSA has approached its shareholders for possible support. Government owns 75 per cent of ACSA.

**Eskom**

Eskom continues to rely on government support and borrowing to run its operations. The power utility received R49 billion of its equity allocation by 31 March 2019. It used R320 billion of its R350 billion guarantee, with an additional R7 billion committed, leaving R23 billion available on the existing facility by 30 June 2020. By 30 September 2020, R6 billion of the R56 billion equity allocation for 2020/21 had been provided to Eskom. The utility has made some progress in implementing its turnaround plan by achieving some targeted cost savings, although lockdowns are likely to have reduced Eskom's revenues during 2020. The utility began implementing revised business models for each division and appointed divisional boards at the end of March 2020. Eskom continues to report to the Ministers of Finance and Public Enterprises on its compliance with the conditions imposed in terms of the Special Appropriation Act (2019).

**Land Bank**

Following a credit rating downgrade in response to its deteriorating financial position, the Land Bank experienced a liquidity shortfall as investors failed to refinance debt. It began defaulting on its debt obligations in April 2020. Government allocated R3 billion to stabilise the Land Bank through the June 2020 special adjustments budget. This funding, and collections from loan book repayments, allowed the entity to start paying overdue interest from August 2020. It is engaging with its creditors to restructure capital repayments on debt that is in default. To ensure financial sustainability, the Land Bank is focused on optimising its equity base and restructuring its assets and liabilities. This process depends on further shareholder recapitalisation and the reduction of its loan assets to retire some of its debt. The Land Bank has approached government for additional financial support.

**Road Accident Fund**

The Road Accident Fund (RAF) is government's largest contingent liability. The RAF's accumulated deficit is projected to grow to R593 billion by 2022/23. The Road Accident Benefit Scheme, which government developed to reduce this liability, was rejected by Parliament in August 2020 and the liability will continue to grow.

**South African National Roads Agency Limited**

The South African National Roads Agency Limited (SANRAL) is unable to meet its financing obligations. It will not generate sufficient cash from its toll portfolio to settle operational costs and debt redemptions falling due in March and September 2021. Since 2014/15, SANRAL has incurred annual average losses of R2.5 billion. Consequently, the first phase of the Gauteng Freeway Improvement Project has not received periodic maintenance, and the second and third phases have been delayed. The result is increased congestion and deterioration in the quality of Gauteng's highway network. Other national toll roads are also experiencing financial difficulty, because toll tariff increases granted by the Minister of Transport have been below what was agreed to in the toll concession contracts. This shortfall will cost the fiscus an additional R300 million in 2020/21.

As of 31 March 2020, SANRAL had used R39 billion of its total government guarantee of R37.9 billion. Over the medium term, SANRAL is expected to repay R10.7 billion of maturing debt obligations and R10.8 billion of interest payments.

## Conclusion

The outlook for fiscal risks has continued to deteriorate over the past year. Over the medium to long term, the public finances will remain vulnerable to the four principal risks covered in this statement. Achieving the economic and fiscal objectives set out in this *Medium Term Budget Policy Statement* will require a significant effort across the entire public sector to prevent these risks from materialising – and, where that is not possible, to mitigate and manage their consequences.