5

Asset and liability management

South Africa has established itself as a credible and competitive borrower in both the domestic and foreign markets. In the past year, the RSA sovereign credit rating was upgraded by Moody's Investors Service and placed on a positive review by Fitch Ratings, increasing the attractiveness of the country as a sought-after destination for investors seeking to diversify their investment portfolios. Prudent debt management helped to deepen the domestic capital markets, contributing to a reduction in state debt costs from 3,6 per cent of GDP in 2003/04 to 3,5 per cent in 2004/05.

In line with Government's objective of diversifying its debt portfolio and creating premium savings instruments for the public, retail bonds have been successfully introduced.

Priorities for the year ahead include clarification of dividend policies of state enterprises, an assessment of treasury operations of state owned entities and a review of the mandates of development finance institutions, as part of Government's broader restructuring strategy. The focus of Treasury's risk management framework has shifted from managing capital market risks to include government-wide risk oversight, with a view to quantifying, monitoring and managing Government's financial exposure across a broad set of contingent risks.

Continuous improvements in cash management processes have allowed the Government's non-interest bearing liquidity buffer with the Reserve Bank to be reduced to R50 million. Investments of surplus cash in 2004/05 earned an estimated R1,7 billion in interest.

Introduction

Economic conditions support domestic bond market

The domestic bond markets continued their strong performance during 2004/05 on the back of the stronger rand, lower domestic inflation, lower interest rates and declining bond yields in major international markets. Prudent debt management in a volatile environment also contributed to the strong performance of the government bond market.

Smoother maturity profile eases debt service costs

In line with Government's debt management objective of reducing debt service costs subject to acceptable risk levels, the Treasury introduced competitively priced funding instruments spread across the yield curve, which created a smooth maturity profile of the domestic debt portfolio. It also contributed to lower debt service costs. The government debt portfolio was further diversified through the successful launch of RSA Retail Bonds in May 2004.

Moody's upgrades SA credit rating

Foreign debt management over the past year focused on the refinancing of maturing foreign loans and the financing of the arms procurement programme. The RSA sovereign credit rating was upgraded by Moody's Investors Service and placed on a positive review by Fitch Ratings. This contributed to a further narrowing of the sovereign risk premium on foreign debt.

This chapter provides a brief overview of the performance of South African bonds in domestic and foreign markets, a review of the financing of the 2004/05 borrowing requirement and the financing programme for 2005/06. It includes projections of state debt costs, a profile of Government's debt portfolio and an update on asset and risk management operations.

Developments in South Africa's debt markets

Domestic bond market developments

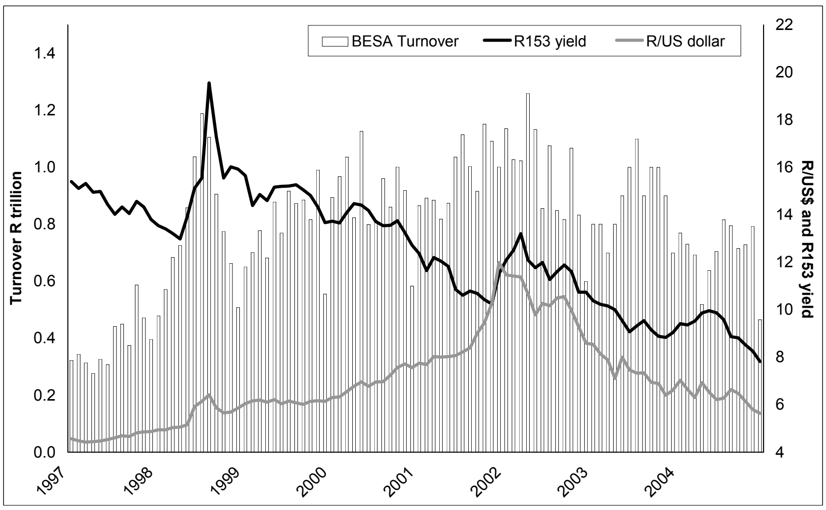
Higher bond yields in first quarter of 2004

Yields on government bonds increased during the first quarter of 2004 due to global uncertainty, especially volatility in the US dollar and euro markets. As a result, the yield on the five-year R153 (13,0%; 2009/10/11) bond increased from 9,0 per cent to 10,3 per cent.

Bond yields traded at record low levels during 2004

The strength of the rand against the US dollar in 2003 and 2004 led to decreasing inflation expectations and a rally in bond yields at the beginning of May 2004. The yield on the R153 bond declined from 9,8 per cent at the beginning of May 2004 to a record low level of 7,8 per cent in December 2004. Yields on inflation-linked bonds declined on average by 25 basis points (bps) during 2004. The yield on the R189 (6,25%; 2013) bond declined from 3,96 per cent to 3,74 per cent during the year.

Figure 5.1 Turnover in the domestic bond market, Rand/US$ exchange rate and R153 bond yield



Declining bond market turnover

Although demand for fixed income assets has remained strong, turnover on the Bond Exchange of South Africa (BESA) declined by R2,3 trillion, from R10,7 trillion in 2003 to R8,4 trillion, in 2004. This is partially explained by the attractiveness of equity investments as economic conditions and corporate earnings improved.

Continued foreign investor demand

After net sales of R8,1 billion worth of South African domestic bonds in 2003, foreign investors purchased a net R0,4 billion in 2004. This occurred in an environment of decreasing yields and a firming exchange rate.

R153 and R194 bonds most liquid

The turnover ratios of Government benchmark bonds are summarised in table 5.1. The R153 and the R194 bonds were the most liquid. The new bonds issued in 2004 – the R203 and R204 – are already showing good turnover ratios.

Table 5.1 Turnover in domestic bonds, 2003 and 2004

Bond R billion	2003 Turnover ratio[1]	2004 Nominal issues	 Market turnover	 Turnover ratio[1]
Fixed income				
R153 (13,0%; 2009/10/11)	33,5	97,1	2 761,4	28,4
R157 (13,5%; 2014/15/16)	19,9	53,8	1 049,8	19,5
R186 (10,5%; 2025/26/27)	10,3	31,8	301,1	9,5
R194 (10,0%; 2007/08/09)	26,7	70,9	1 904,6	26,9
R201 (8,75%; 2014)	4,9	27,3	345,9	12,7
R203 (8,25%; 2017)	–	10,1	137,4	13,6
R204 (8,0%; 2018)	–	4,2	44,2	10,5
Inflation linked				
R189 (6,25%; 2013)	0,9	16,7	10,3	0,6
R197 (5,5%; 2023)	2,3	11,4	8,1	0,7
R198 (3,8%; 2008)	3,7	3,7	13,9	3,8
R202 (3,45%; 2033)	7,2	2,6	8,7	3,4

1. Turnover ratio represents the market turnover divided by the nominal outstanding issue of a bond.

Domestic market continues to improve

The development and depth of the domestic bond market have continued to improve, in response to the Treasury's debt management reforms. A derivative market in fixed income instruments will soon be formalised, which is expected to further add to liquidity.

Corporate bond issues continued to increase

Growth in the non-sovereign bond market continued in 2004, both in size and diversification in instruments. The low interest rate environment and low debt-to-equity ratios created favourable conditions for corporate institutions to raise funds in the debt market. Approximately R50 billion was issued in non-government bond securities. The market for securitised products has also expanded, with a total issuance of R28,2 billion of asset-backed securities.

Municipalities re-entering capital markets

Alongside rising corporate activity, municipalities also entered the capital market. The City of Johannesburg issued two bonds to the value of R1,0 billion each in 2004. The turnover of municipal bonds on BESA reached R12,2 billion in 2004.

South Africa's credit ratings in perspective

Rating agencies dealing with sovereign risks seek to assess the capacity and willingness of a sovereign government to service its debt within the maturity dates and in accordance with the conditions agreed upon with creditors at the time the loans were contracted. The outcome of such an assessment is translated into a certain rating. Each agency has its own rating taxonomy, generally on a scale of A,B,C and D. On the scale used by Standard & Poor's and Fitch Ratings, the top rating is "AAA" and the bottom "D", while with Moody's Investors Service the top is "Aaa" and the worst is "C". A lower rating reflects a higher probability of default and vice versa. Governments rated above "BBB-" or "Baa3" are known as "investment grade", while those below BBB- / Baa3, fall into the "speculative grade" category. International investors make use of credit ratings as one basis for selecting between investment options.

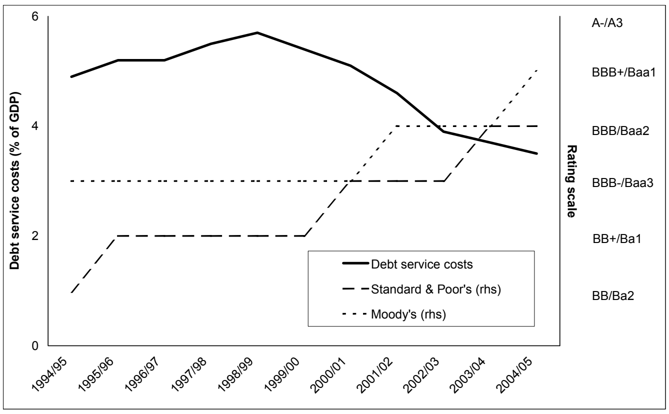
Since 1994, South Africa's credit ratings have steadily improved, reflecting progress in macroeconomic reform and economic conditions. South Africa was assigned an investment grade rating of Baa3 by Moody's Investors Service in 1994, while Fitch Ratings and Standard & Poor's assigned a speculative rating of BB.

Sovereign ratings measure the risk of a country defaulting on its foreign currency debt service obligations. Relevant factors in determining a rating include the ability of the economy to generate foreign currency, the magnitude of short term debt, total debt stock, and the level of international reserves as well as the ratio of external debt to current account receipts.

South Africa's negative net open forward currency position (NOFP), which was finally cleared in 2004, was frequently cited by rating agencies as a critical source of external vulnerability. On the other hand, the recent increase in South Africa's official gross foreign exchange reserves, which stood at US$ 15,1 billion at the end of January 2005, represent a material improvement in the country's risk profile.

By 2005, South Africa had been upgraded by all three rating agencies to an investment grade (Moody's Investors Service Baa1, Fitch Ratings and Standard & Poor's BBB). In addition, the improved macroeconomic environment and the ability of South Africa to fund its entire borrowing requirement from the domestic market if necessary, have bolstered the country's position in international capital markets. The subsequent tightening of premia contributed to the decline of debt service costs as a percentage of GDP from a high of 5,7 per cent in 1998/99 to a low of 3,5 per cent in 2004/05. Reduced debt service costs have enabled Government to channel significantly more resources to expenditure on public services.

Debt service costs and credit ratings history: 1994 -2004



South African issuances in international capital markets

In 2004/05, capital markets were volatile, primarily as a result of a weaker US dollar, higher oil prices, widening US current account and fiscal deficits, as well as the rising interest rate environment.

US$1,0 billion 10-year global bond issued in 2004

Despite the volatility in the market, Government issued a US$1,0 billion 10-year global bond in May 2004, maturing in June 2014, with a coupon of 6,5 per cent. The coupon of 6,5 per cent was the lowest coupon achieved by South Africa for US dollar borrowing since South Africa accessed international capital markets in 1994. The spread on this bond tightened from 195 bps over the underlying 10-year US Treasury bond at issue to a record low of 89 bps on 10 January 2005.

Rating upgraded to higher investment grade

Demand for the bonds was enhanced by the positive news from two rating agencies, which emphasised a reduced sovereign credit risk as a result of sound macroeconomic fundamentals. Fitch Ratings placed the RSA on positive review on 14 October 2004, while Moody's Investors Service placed the RSA on credit watch for a possible upgrade on 21 October 2004. Subsequently, Moody's upgraded the RSA's long term foreign currency debt from Baa2 to Baa1 on 11 January 2005. All foreign bond spreads have tightened relative to underlying international benchmark bonds, as shown in table 5.2.

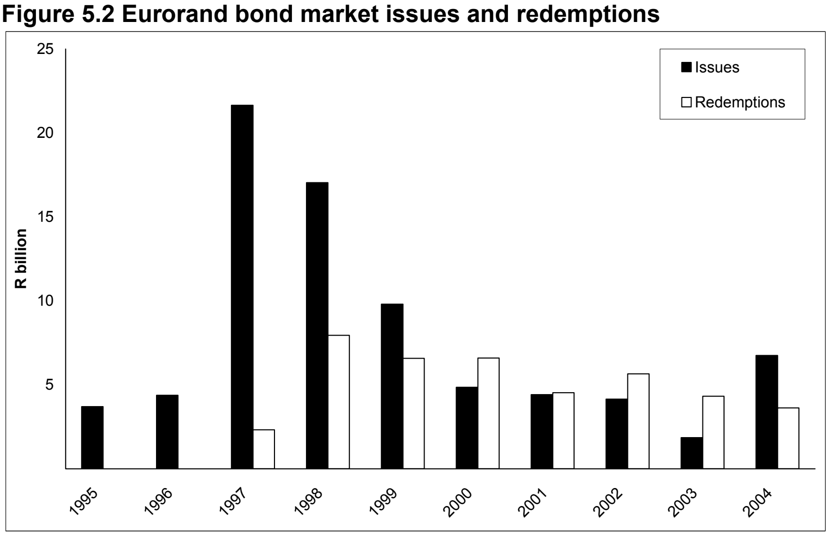
Table 5.2 Foreign bonds performance, 14 February 2005

Bond Million	Coupon %	Issue date	Maturity date	Issue spread bps[1]	Current spread bps[1]
US Dollars					
300	8,375	October 1996	October 2006	195	55
1 500	9,125	May 1999	May 2009	362/275[2]	94
1 000	7,375	April 2002	April 2012	240	102
1 000	6,500	June 2004	June 2014	195	97
500	8,500	June 1997	June 2017	183	134
Euros					
500	6,750	May 1999	May 2006	328	35
500	7,000	April 2001	April 2008	272	50
1 250	5,250	May 2003	May 2013	142	84

1. Spreads (percentages) are quoted relative to underlying international benchmark bonds. One basis point (bp) is 0,01 of a per cent.

2. This bond was issued at 362 bps over the US Treasury bond in 1999 and was re-opened in 2000 at a spread of 275 bps over the US Treasury.

Figure 5.2 Eurorand bond market issues and redemptions



Demand for euro-rand bonds continued

An international market in rand-denominated bonds developed and supplements the growing market for South African foreign bonds. The performance of the rand, both in terms of its level and volatility, as well as lower interest rates, resulted in increased issuance of rand-denominated bonds in international markets. In 2004 the amount of eurorand bonds in issue rose to R200,7 billion, compared with R197,0 billion in 2003. Greater activity in this market creates demand for rands in international foreign exchange markets and also adds to the demand for domestic bonds.

Net borrowing requirements

Government's net borrowing requirement is the sum of the budget deficit, extraordinary receipts and extraordinary payments. Table 5.3 sets out the net borrowing requirement for 2003/04, a revised estimate for 2004/05 and estimates for the MTEF period.

Table 5.3 Net borrowing requirements, 2003/04 – 2007/08

	2003/04	2004/05		2005/06	2006/07	2007/08
R million	**Outcome**	**Budget**	**Revised**	**Medium-term estimates**		
Budget deficit	29 231	41 948	32 152	47 950	50 966	50 251
Extraordinary receipts	-1 598	-2 742	-1 719	-1 529	-527	-712
Premiums on loan transactions [1]	*-2 084*	*-242*	*-1 706*	*-503*	*-527*	*-712*
Restructuring proceeds	*486*	*-2 500*	*-13*	–	–	–
Agricultural Debt Account surrender	–	–	–	*-1 026*	–	–
Extraordinary payments	7 443	7 000	7 136	7 000	–	4 328
Premiums on loan transactions [1]	*167*	–	*136*	–	–	–
Defrayal of GFECRA losses [2]	*7 000*	*7 000*	*7 000*	*7 000*	–	–
SA Housing Board debt takeover	*276*	–	–	–	–	–
Saambou Bank contingent liability	–	–	–	–	–	*4 328*
Total	**35 076**	**46 206**	**37 569**	**53 421**	**50 438**	**53 867**

1. Premiums received or incurred on loan issues, bond switch transactions and conversions of foreign loans.

2. Payments made to the Reserve Bank to defray realised losses on the Gold and Foreign Exchange Contingency Reserve Account.

The net borrowing requirement will increase from an expected R37,6 billion in 2004/05 to an average of R52,6 billion per year from 2005/06 to 2007/08. In 2004/05, provision was made for extraordinary receipts of R2,7 billion comprising proceeds from the restructuring of state owned entities (R2,5 billion) and premiums on bonds issued to finance the borrowing requirement (R242,1 million).

Extraordinary receipts of R1,7 billion in 2004/05

Premiums received on domestic bond issues and on switches entered into with the Reserve Bank for monetary management purposes amounted to R1,7 billion in 2004/05, or R1,5 billion more than budgeted due to a general decline in bond yields across different maturities.

Proceeds from restructuring of state owned entities are revised downwards to R13,3 million, which was received from the sale of Aventura Resorts. The proceeds from the sale of SAFCOL will also not be realised in 2004/05 as the Competition Commission is still reviewing the merger application.

In 2005/06, R1,0 billion from the Agricultural Debt Account at the Corporation for Public Deposits will be transferred to the National Revenue Fund. Together with premiums on bond issues and switch transactions, total extraordinary receipts for 2005/06 are R1,5 billion.

Extraordinary receipts of R1,5 billion in 2005/06

Provision is made for extraordinary receipts of R527,4 million in 2006/07 and R712,2 million in 2007/08, which represent premiums on the issuance of domestic bonds. Extraordinary payments in 2004/05 are estimated to increase by R136,3 million. This mainly provides for premiums incurred in switch transactions with the Reserve Bank for monetary management purposes.

Extraordinary payments in 2005/06 include the issuing of R7 billion in bonds to the Reserve Bank in terms of the Gold and Foreign Exchange Contingency Reserve Account Defrayal Act, 2003. These payments go towards settling realised losses on the Gold and Foreign Exchange Contingency Reserve Account. No extraordinary payments are expected in 2006/07, while the estimated contingent liability of R4,3 billion relating to Saambou Bank will realise in 2007/08.

Saambou liability will be realised in 2007/08

Financing of the net borrowing requirement

Government's net borrowing requirement is financed through domestic short and long term loans, foreign loans and changes in cash and other balances. Table 5.4 provides information on the financing of Government's net borrowing requirement for 2003/04 and 2004/05, with projections for the period 2005/06 to 2007/08.

Table 5.4 Financing of net borrowing requirements, 2003/04 – 2007/08

	2003/04	2004/05		2005/06	2006/07	2007/08
R million	Outcome	Budget	Revised	Medium-term estimates		
Domestic short-term loans (net)	6 695	6 000	6 000	4 974	6 000	6 000
Treasury bills	*6 550*	*6 000*	*5 850*	*6 000*	*6 000*	*6 000*
Corporation for Public Deposits	*145*	–	*150*	*-1 026*	–	–
Domestic long-term loans (net)	31 123	34 328	31 045	25 768	40 299	42 247
Market loans	*50 554*	*53 860*	*50 395*	*45 140*	*65 366*	*70 591*
Extraordinary issues	*7 206*	*7 000*	*7 000*	*7 000*	–	–
Redemptions	*-26 637*	*-26 532*	*-26 350*	*-26 372*	*-25 067*	*-28 344*
Foreign loans (net)	1 045	5 878	4 795	12 039	2 639	4 120
Market loans	*10 557*	*7 400*	*6 405*	*9 390*	*7 090*	*7 870*
Arms procurement loan agreements	*3 771*	*4 675*	*3 683*	*4 708*	*3 860*	*2 800*
World Bank loans	*19*	–	*43*	–	–	–
Redemptions (including revaluation of loans)	*-13 302*	*-6 197*	*-5 336*	*-2 059*	*-8 311*	*-6 550*
Change in cash and other balances[1]	-3 787	–	-4 271	10 640	1 500	1 500
Opening balance	*8 882*	*6 500*	*14 869*	*20 640*	*11 500*	*11 500*
Cash balance	*9 730*	*6 500*	*12 669*	*19 140*	*10 000*	*10 000*
Surrenders/late requests	*1 002*	–	*2 200*	*1 500*	*1 500*	*1 500*
Cash flow adjustment[2]	*-1 850*	–	–	–	–	–
Closing balance	*-12 669*	*-6 500*	*-19 140*	*-10 000*	*-10 000*	*-10 000*
Total[3]	**35 076**	**46 206**	**37 569**	**53 421**	**50 438**	**53 867**

1. A positive change indicates a reduction in cash balances.

2. Represents a reconciliation of actual revenue and actual expenditure against National Revenue Fund flows.

3. Full details are reflected in table 1 of Annexure B.

Opening cash balances and surrenders of R14,9 billion in 2004/05

For 2004/05, the opening cash balances in the exchequer and the tax and loan accounts amounted to R14,9 billion against the budgeted amount of R6,5 billion. The higher opening balance is due to R6,2 billion prefunding in 2003/04 and the net of R2,2 billion surrenders/late requests of money by departments.

Year-end cash balances of R19,1 billion in 2004/05

The opening balance of R14,9 billion for 2004/05 will increase by R6,4 billion to give a closing balance of R19,1 billion. This is mainly due to the net borrowing requirement decreasing by R8,6 billion and R4,4 billion lower domestic and foreign loan issues in 2004/05.

Cash balances will be run down by R10,6 billion to finance part of the borrowing requirement for 2005/06. Year-end balances of R10,0 billion are anticipated for 2005/06 to 2007/08.

Steady increase in short-term loans

Table 5.5 shows the volume of outstanding domestic short-term loans. The net increase in short-term loans in 2004/05 is R6,0 billion. Treasury bills were issued at a weighted average yield of 7,5 per cent against a budget estimate of 9,9 per cent. The stock of treasury bills will increase by R6,0 billion over the MTEF, although borrowing from the Corporation for Public Deposits will decrease by R1,0 billion in 2005/06.

Table 5.5 Domestic short-term loans outstanding, 2003/04 – 2004/05

R million	2003/04 Outcome	2004/05 Estimate
Treasury bills	29 922	35 922
Shorter than 91-days [1]	*1 322*	*1 472*
91-days	*23 400*	*29 250*
182-days	*5 200*	*5 200*
Other[2]	10	10
Total	**29 932**	**35 932**

1. *Mainly 1-day bills issued to the Corporation for Public Deposits.*
2. *Loan levies and former Bophuthatswana bonus bonds.*

Domestic bonds decrease by R3,3 billion in 2004/05

Net domestic long term loans in 2004/05 are projected to decrease by R3,3 billion inclusive of R7,0 billion nil coupon bonds issued to the Reserve Bank. The decrease in domestic long term loans is largely as a result of prefunding done in 2003/04 for 2004/05.

Fixed income bonds issued at an average yield of 9,4 per cent

Table 5.6 provides a breakdown of the R43 billion in government bonds issued for the purposes of financing in 2004/05 up to 31 January 2005. Fixed income bonds remain the major source of financing, constituting 78,6 per cent of total issuance in 2004/05. Inflation-linked bonds and the floating rate bond constitute 18,5 per cent and 2,9 per cent, respectively. Fixed income bonds were issued at a weighted average yield of 9,4 per cent (budgeted 9,0 per cent), while inflation-linked bonds were issued at a weighted average real yield of 3,7 per cent.

Table 5.6 Domestic bonds issued for financing, 2004/05

As at 31 January 2005 R million	Cash value	Average yield %
Fixed income	33 765	
R153 (13,0%; 2009/10/11)	*527*	*8,78*
R157 (13,5%; 2014/15/16)	*1 381*	*9,58*
R186 (10,5%; 2025/26/27)	*2 726*	*8,73*
R194 (10,0%; 2007/08/09)	*3 411*	*9,27*
R201 (8,75%; 2014)	*9 389*	*9,82*
R203 (8,25%; 2017)	*10 397*	*9,50*
R204 (8,0%; 2018)	*4 728*	*8,99*
Retail	*1 206*	*8,95*
Inflation linked	7 970	
R189 (6,25%;2013)	*2 771*	*3,70*
R197 (5,5%; 2023)	*3 315*	*3,76*
R198 (3,8%;2008)	*1 553*	*3,62*
R202 (3,45%; 2033)	*331*	*3,79*
Floating rate	1 249	
R199 (floating; 2007)	*1 249*	*8,03*
Total	**42 984**	

Fixed income bond issuances spread mainly across three bonds

The fixed income bond issuance was concentrated in three bonds, the R201 (8,75%; 2014), R203 (8,25%; 2017) and R204 (8,0%; 2018), constituting 72,6 per cent of the total issuance. The shorter-dated R194 (10%; 2007/08/09) and the longer-dated R186 (10,5%; 2025/26/27) bonds make up 10,1 and 8,1 per cent of the total fixed income bond issuance, respectively.

The shorter-dated inflation-linked bond, the R198 (3,8%; 2008), constitutes 19,5 per cent of the total inflation-linked bond issuance. The concentration of inflation-linked bond issuance was in the R197 (5,5%; 2023) bond, taking up 41,6 per cent of the total inflation-linked bond issuance, followed by the R189 (6,25%; 2013) bond at 34,8 per cent, with the ultra-long R202 (3,45%; 2033) bond contributing 4,1 per cent. The fully developed inflation-linked bond yield curve has become a useful tool for investors to project future inflation.

The break-even inflation derived from the R189 (6,25%; 2013) narrowed to an average of 4,86 per cent in the last quarter of 2004, compared to the 6,24 per cent during the first quarter of 2004. This indicates that inflation expectations have been on a downward trend.

Switches in government bonds of R8,4 billion effected with the SARB

Table 5.7 depicts switches in government bonds for 2004/05. The Reserve Bank is allowed to convert its current bond portfolio and future nil coupon bonds into cash or short term interest bearing instruments in terms of an agreement with the National Treasury. Switches of R8,4 billion were effected with the Reserve Bank. The nominal value of Government's debt portfolio declined by R323 million due to the switch transactions in 2004/05.

Table 5.7 Switches in domestic bonds for monetary management purposes, 2004/05

Source bond		Destination bond	
R million			
Z016 (nil coupon; 2014)	1 000	R153 (13,0%; 2009/10/11)	859
Z016 (nil coupon; 2014)	1 000	R201 (8,75%; 2014)	1 073
Z016 (nil coupon; 2014)	3 000	R194 (10,0%; 2007/08/09)	2 946
Z016 (nil coupon; 2014)	2 000	R157 (13,5%; 2014/15/16)	1 589
R186 (10,5%; 2025/26/27)	1 000	R201 (8,75%; 2014)	1 224
R151 (12,0%; 2005)	354	R152 (12,0%; 2006)	340
Total	**8 354**	**Total**	**8 031**

In addition to Government's bond issues in the market, the Reserve Bank sold R1,6 billion of bonds into the market and entered into bond switches of R7,7 billion for monetary management purposes.

Foreign loan issues of R10,1 billion

Foreign loan issues as at 31 January 2005 are set out in table 5.8. In 2004/05, provision was made for foreign capital market loans of R7,4 billion and R4,7 billion for arms procurement. To date, R9,8 billion has been issued. A further R310,0 million will be drawn on the arms procurement loan agreements.

To take advantage of the low interest rate environment in global markets, the interest rate of all the rollover options in terms of the arms procurement loan agreements were fixed. In 2003, 61,0 per cent was fixed at an average rate of 4,9 per cent and the remaining 39,0 per cent was fixed during 2004 at an average rate of 5,2 per cent.

Table 5.8 Foreign loan issues, 2004/05

As at 31 January 2005 **R million**	
Market loan	6 405
US$ Global Bond 2014 (6,50%)	*6 405*
Concessionary: World Bank Loan	43
Arms procurement loan agreements	3 373
AKA-Commerzbank (Submarines)	*1 268*
AKA-Commerzbank (Corvettes)	*587*
Societe Generale (Corvettes)	*165*
Mediocredito Centrale (Light utility helicopters)	*104*
Barclays (Hawk / Gripen)	*1 249*
Total	**9 821**

Government has drawn R43,0 million on World Bank loan facilities to provide financial and technical support for the municipal financial management project (R9,3 million) and an industrial competitiveness and job creation project (R33,7 million).

Total foreign loans, inclusive of disbursements on arms procurement loan agreements and World Bank loans, equivalent to US$ 2,3 billion, US$ 1,5 billion and US$ 1,4 billion are to be raised over the MTEF period.

Loan redemptions

Table 5.9 sets out scheduled loan redemptions for 2003/04 and 2004/05, as well as medium term estimates for 2005/06 to 2007/08.

Loan redemptions of R31,7 billion in 2004/05

Total loan redemptions amounted to R31,7 billion in 2004/05, R1,0 billion lower than anticipated at the time of the 2004 Budget, mainly due to the stronger rand.

Loan redemptions of R28,4 billion are projected for 2005/06, including R2,1 billion in foreign loan redemptions. The amount will increase to R34,9 billion in 2007/08.

Table 5.9 Loan redemptions, 2003/04 – 2007/08

R million	2003/04 Outcome	2004/05 Budget	2004/05 Revised	2005/06	2006/07	2007/08
				Medium-term estimates		
Domestic loans[1]	26 637	26 532	26 350	26 372	25 067	28 344
Foreign loans	13 302	6 197	5 336	2 059	8 311	6 550
Principal	*16 799*	*4 006*	*4 035*	*1 311*	*5 961*	*5 448*
Revaluation	*-3 497*	*2 191*	*1 301*	*748*	*2 350*	*1 102*
Total	**39 939**	**32 729**	**31 686**	**28 431**	**33 378**	**34 894**
Excludes:						
Source bonds in switch auctions	10 170	7 000	8 354	7 000	10 000	–

1. Excludes an amount of R10 billion in 2006/07 which will be refinanced through a switch programme.

Government's financing programme for 2005/06

The financing programme for 2005/06 takes the following issues into consideration:

- Higher public sector borrowing requirements
- Decreasing liquidity in the domestic bond market
- Increasing current account deficit
- Global market volatility
- Improving economic growth prospects; and
- The stable inflation outlook.

Net borrowing of R53,4 billion in 2005/06

The net borrowing requirement for 2005/06 is estimated at R53,4 billion. This amount will be financed by net increases in short term loans of R5,0 billion, R25,8 billion in domestic long term loans including retail bonds, R12,0 billion in foreign loans and the rundown of cash balances by R10,6 billion.

Broader range of treasury bills

Treasury bills will be increased by R6,0 billion. An effort will be made to develop a fuller treasury bill yield curve. The current range of 3- and 6-month treasury bills will be extended to include 1- and 9-month treasury bills. Treasury bills with a 12-month maturity will not be issued due to their limited in-year role for cash flow management.

Losses of R7 billion settled with the Reserve Bank

Nil coupon bonds of R7,0 billion will be issued to the Reserve Bank to defray realised losses on the Gold and Foreign Exchange Contingency Reserve Account. The Reserve Bank will be allowed to convert its current bond portfolio and the nil coupon bonds into cash or short-term interest bearing instruments.

Continued funding in benchmark bonds

Domestic long-term loan issues in 2005/06 will be in the existing fixed income benchmark bonds, the R153, R157, R186, R201, R203 and the R204, and inflation-linked bonds, the R189, R197, R198 and the R202.

New fixed income and floating rate bonds

Provision has been made for the issuance of two new fixed income bonds, maturing in 2013/14 and 2019/20, and a floating rate bond maturing in 2011/12. No new inflation-linked bonds will be issued in 2005/06. Issuance of 2-, 3- and 5-year RSA Retail Bonds will continue in 2005/06. No new retail bond instruments will be considered beyond these maturities.

Foreign capital market issuance equivalent to US$ 1,5 billion

The equivalent of US$ 1,5 billion is to be raised in the foreign capital markets in 2005/06. In addition, US$ 752,1 million pertaining to the arms procurement loan agreements is scheduled to be drawn.

Size and structure of Government's debt portfolio

Total government debt

The increase in net loan debt of R38,4 billion since the end of the previous year is explained in table 5.10.

Table 5.10 Increase in government debt, 2004/05

R million	
Financing of net borrowing requirement (net of change in cash balances)	41 841
Discount on new loans	3 268
Revaluation of foreign loan portfolio	-286
Increase in gross loan debt	**44 823**
Change in cash balances at bank[1]	-6 471
Increase in net loan debt	**38 352**

1. A positive change indicates a reduction in cash balances.

Total net loan debt of R481,7 billion by end 2004/05

After taking into account the bank balances of the National Revenue Fund (Government's accounts with the Reserve Bank and commercial banks), total net loan debt is expected to amount to R481,7 billion at the end of March 2005.

Net loan debt to GDP of 36,1 per cent in 2007/08

The composition of government debt since 2001/02 is summarised in table 5.11, and table 7 of *Annexure B* provides a schedule of government debt since 1981. Net loan debt decreased to a projected 34,3 per cent of GDP at the end of 2004/05, from 34,7 per cent at the end of 2003/04. Based on current projections, total net loan debt is expected to increase to 36,1 per cent of GDP over the next three years.

Table 5.11 Total government debt, 2001/02 – 2007/08

R billion	2001/02	2002/03 Outcome	2003/04	2004/05 Estimate	2005/06	2006/07 Medium-term estimates	2007/08
Total domestic debt	350,5	352,5	391,3	431,6	465,7	517,2	569,4
Marketable domestic debt	*348,5*	*350,5*	*389,3*	*428,1*	*461,3*	*511,3*	*562,0*
Non-marketable domestic debt	*2,0*	*2,0*	*2,0*	*3,5*	*4,4*	*5,9*	*7,4*
Total foreign debt[1]	82,0	74,3	64,7	69,2	84,8	96,7	107,0
Total gross loan debt	**432,5**	**426,8**	**456,0**	**500,8**	**550,5**	**613,9**	**676,4**
Percentage of GDP	*41,3%*	*35,8%*	*35,7%*	*35,7%*	*36,0%*	*36,7%*	*36,6%*
Less: National Revenue Fund bank balance	-6,6	-9,7	-12,7	-19,1	-10,0	-10,0	-10,0
Total net loan debt[2]	**425,9**	**417,1**	**443,3**	**481,7**	**540,5**	**603,9**	**666,4**
Percentage of GDP	*40,6%*	*34,9%*	*34,7%*	*34,3%*	*35,4%*	*36,1%*	*36,1%*

1. Forward estimates are based on National Treasury's projections of exchange rates.

2. The total net government loan debt is calculated with due account of the bank balances of the National Revenue Fund (balances of Government's accounts with the Reserve Bank and the Tax and Loans Accounts with commercial banks).

Maturity and composition of government debt

Moderate increase in maturity and duration of domestic debt

Table 5.12 sets out the average maturity and duration of domestic marketable bonds. The average maturity of the domestic marketable bond portfolio has increased from 8,1 years in 2003/04 to 8,2 years in 2004/05. The weighted average term (duration) of interest and redemption cash flows has also increased from 4,9 years for 2003/04 to 5,3 years for 2004/05. This can be ascribed to the issuance of bonds predominantly in the medium- and longer- ends of the yield curve and the increasing issuance of inflation-linked bonds.

Table 5.12 Maturity distribution of domestic marketable bonds, 2001/02 – 2004/05

Years Percentage of total	2001/02	2002/03	2003/04	2004/05 Estimate
0 – 3	22,5	24,6	21,6	22,0
3 – 7	20,3	24,7	33,6	32,5
7 – 10	28,0	18,9	13,4	17,0
10 – 19	21,4	21,2	19,5	19,0
Longer than 19	7,8	10,6	11,9	9,5
Years				
Average duration[1]	4,7	5,0	4,9	5,3
Average maturity	8,5	8,3	8,1	8,2

1. The weighted average term (duration) of interest and redemption cash flows.

Fixed income bonds are 79,5 per cent of total domestic debt

Table 5.13 sets out the composition of domestic debt since 2001/02. By the end of 2004/05, fixed income bonds are expected to constitute 79,5 per cent, floating rate bonds 2,0 per cent and inflation-linked bonds 9,1 per cent of total domestic debt. Treasury bills will account for 8,3 per cent of total domestic debt.

Table 5.13 Composition of domestic debt by instrument type, 2001/02 – 2004/05

R billion	2001/02	2002/03 Outcome	2003/04	2004/05 Estimate
Bonds	330,6	328,6	360,8	395,2
Fixed income	*307,2*	*310,7*	*321,7*	*343,2*
Floating rate	*5,8*	*0,6*	*7,6*	*8,8*
Zero coupon	*3,5*	*2,3*	*2,3*	*2,3*
Inflation linked	*14,1*	*15,0*	*29,2*	*39,4*
Retail	–	–	–	*1,5*
Treaury bills[1]	19,0	23,2	29,9	35,9
Other[2]	0,9	0,7	0,6	0,5
Total	**350,5**	**352,5**	**391,3**	**431,6**

1. Includes 1-day bills issued to the Corporation for Public Deposits.

2. Loan levies, former regional authorities and Namibian debt.

Foreign debt 13,8 per cent of total debt in 2004/05

A currency breakdown of foreign debt obligations from 2001/02 is set out in table 5.14. Foreign debt varies from 14,2 per cent of total debt in 2003/04 to a projected 13,8 per cent in 2004/05, and 15,8 per cent in 2007/08.

Table 5.14 Currency breakdown of foreign debt, 2001/02 – 2004/05

Percentage of total	2001/02	2002/03	2003/04	2004/05 Estimate
Euro	36,0	28,2	44,6	42,7
United States Dollar	44,2	54,2	36,4	42,8
Japanese Yen	17,0	14,6	15,3	10,5
British Pound	2,2	2,1	2,6	2,7
Swedish Krone	0,3	0,5	0,6	0,8
Gold	0,3	0,4	0,5	0,5

Contingent liabilities

Contingent liabilities of R130,8 billion

Government's consolidated financial statements show total contingent liabilities amounting to R130,8 billion at the end of 2003/04 (table 5.15).

Guarantee commitments of R79,6 billion

The National Treasury manages the borrowing powers of general government bodies and the issuing of guarantees to state owned entities. Government's guarantee commitments, amounting to R79,6 billion at the end of 2003/04, are set out in table 8 of *Annexure B.*

In 2004/05, guarantees of R6,7 billion were provided to public entities, of which R6,0 billion was accounted for by shareholder's assurances provided to Transnet for South African Airways (Pty) Ltd (SAA). This replaced the initial R7,0 billion guarantee that was issued to Transnet in October 2004 for the SAA hedge book. In 2004/05, guarantee fees received from state owned entities amounted to R40,8 million. The average maturity of loans for which government guarantees were issued in 2004/05 was 10 years.

Table 5.15 Composition of contingent liabilities, 2001/02 – 2003/04

R billion	2001/02	2002/03	2003/04
Guarantees	84,7	69,4	79,6
Domestic	*54,0*	*47,2*	*59,6*
Foreign	*30,7*	*22,2*	*20,0*
Road Accident Fund	18,1	23,8	23,8
Post Retirement Medical Assistance	14,3	14,3	13,4
Export Credit Insurance Corp. S.A. Ltd.	7,2	9,2	7,5
Government's Pension Funds	3,0	3,0	3,0
SASRIA reinsurance cover	1,0	1,0	1,0
Unemployment Insurance Fund	1,3	1,3	2,5
Total	**129,6**	**122,0**	**130,8**

State debt costs

State debt costs declines to 3,2 per cent of GDP by 2007/08

Trends and projections of state debt costs between 2003/04 and 2007/08 are set out in table 5.16. The cost of servicing Government's debt portfolio continues to fall as a percentage of GDP, declining from 3,6 per cent in 2003/04 to an estimated 3,2 per cent by 2007/08.

Table 5.16 State debt cost, 2003/04 – 2007/08

	2003/04	2004/05		2005/06	2006/07	2007/08
R million	Outcome	Budget	Revised	Medium-term estimates		
Interest	46 086	50 172	48 665	53 013	56 524	59 301
Domestic debt	*42 092*	*44 163*	*44 544*	*47 666*	*50 462*	*52 841*
Foreign debt	*3 994*	*6 009*	*4 121*	*5 347*	*6 062*	*6 460*
Management cost	188	230	186	77	39	40
Cost of raising loans	39	30	50	35	40	40
Total	**46 313**	**50 432**	**48 901**	**53 125**	**56 603**	**59 381**
Percentage of GDP	*3,6%*	*3,6%*	*3,5%*	*3,5%*	*3,4%*	*3,2%*

R1,5 billion saving in debt cost for 2004/05

Debt service costs are projected to total R48,9 billion in 2004/05, R1,5 billion lower than budgeted, mainly as a result of a lower net borrowing requirement, lower domestic interest rates and lower foreign interest payments due to the stronger rand.

Debt cost of R53,1 billion for 2005/06

In 2005/06, the cost of servicing state debt is expected to be R53,1 billion. This takes into account a net borrowing requirement of R53,4 billion, as set out in table 5.3, an average coupon rate of 8,9 per cent on domestic fixed income bond issues and an average coupon rate of 4,8 per cent on inflation-linked bonds. Currently, Government's accounting practice provides for interest expenditure to be recorded on a cash basis, while the discount is accrued to debt at the time of issue. For comparative purposes, an accrual-based accounting for the stock of state debt and debt costs since 1994/95 is set out in table 5.17. The amortisation of the discount over the term of the bond results in higher recorded state debt costs, a higher deficit and a lower aggregate of government debt. Amortisation would add R4,1 billion to expenditure in 2004/05, or 0,3 per cent of GDP. The adjusted aggregate of total net loan debt amounts to 32,3 per cent of GDP.

Table 5.17 State debt costs and total debt on an accrual basis, 1994/95 – 2004/05

	Amortised discount R million	Adjustments to state debt cost % of GDP	Total net loan debt at year-end % of GDP	Adjusted total net loan debt at year-end % of GDP
1994/95	1 961	0,4	46,9	41,8
1995/96	3 091	0,5	48,0	42,1
1996/97	3 201	0,5	48,1	42,0
1997/98	3 411	0,5	47,3	41,3
1998/99	3 589	0,5	47,3	41,1
1999/00	3 797	0,5	44,7	39,2
2000/01	4 056	0,4	41,7	36,9
2001/02	6 088	0,6	40,6	36,8
2002/03	4 454	0,4	34,9	31,9
2003/04	4 723	0,4	34,7	32,3
2004/05	4 053	0,3	34,3	32,3

Risk management developments

More comprehensive approach to risk

The scope of risk management has widened from a market risk analysis of Government's debt portfolio to a government-wide risk management approach. One of the lessons of the emerging markets crisis of 1998 was that financial weakness can best be detected through a broad perspective on the various risks affecting the fiscus, including market risk, credit risk and country risk associated with both government assets and liabilities.

Broader risk assessment feeds into Government's funding strategy

The funding strategy is underpinned by market risk considerations. These include liquidity and refinancing risk, inflation risk (re-indexation risk) and currency risk. These are managed by determining an optimal debt maturity profile, a balanced choice between fixed and floating rate debt, and a preferred level and composition of foreign debt. The structure of Government's debt portfolio is also informed by the prevailing macroeconomic conditions and outlook.

Operational guidelines in development

Risk management responsibilities also include the identification, measurement and management of country and credit risks. These are associated, among others, with cash deposits held with counterparties, guarantees provided to state owned entities (contingent liabilities) and other risks. Appropriate policies and operational guidelines are being developed to ensure the effective implementation of the new approach to risk management.

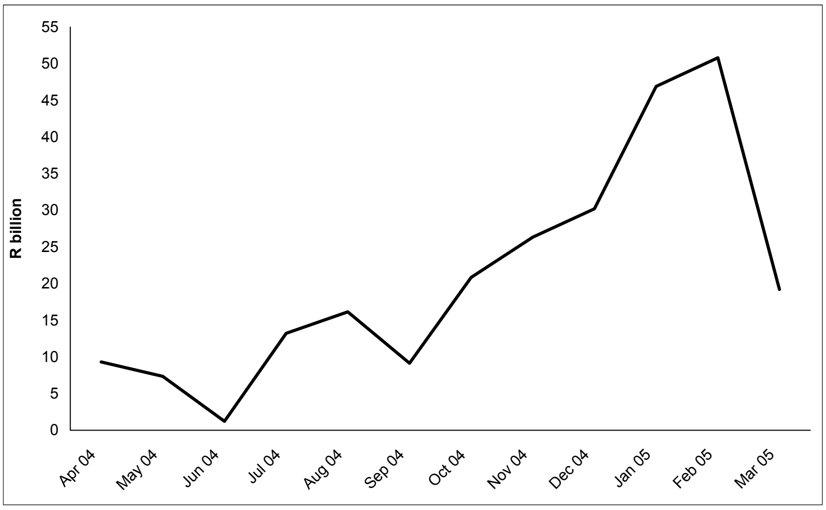
Asset management

Cash management operations

Cash balances peak at R54,6 billion

Cash balances dropped to low levels over May and June 2004 due to seasonally high expenditure and low revenue. Balances increased gradually over the year, reaching a peak of R54,6 billion in February 2005. After loan redemptions, interest and other payments totalling R42,7 billion on 28 February 2005, balances are expected to drop to R19,1 billion by year-end.

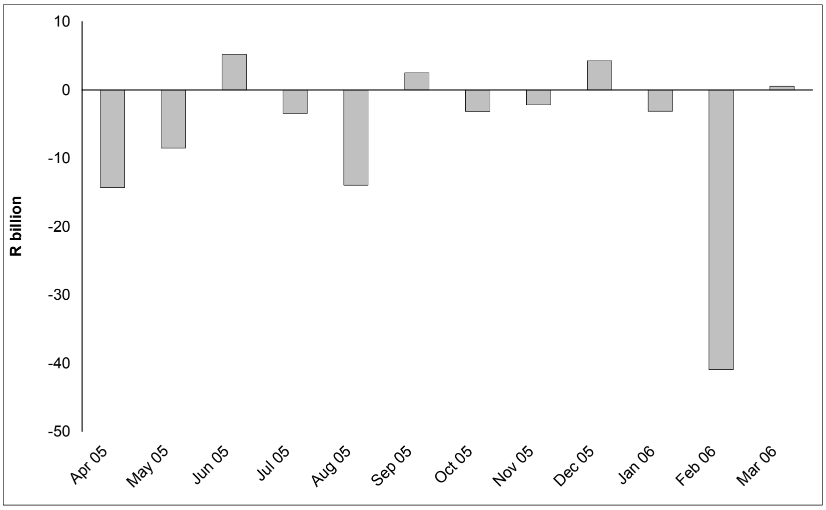
Figure 5.3 Daily cash balances 2004/05



R1,7 billion in interest earned in 2004/05

All surplus cash is deposited in investment accounts on a daily basis with the four major banks. To manage credit risk exposure, interest-bearing deposit accounts are also held with the Reserve Bank and the Corporation for Public Deposits. National Treasury continued to use treasury bills and borrowing from the Corporation for Public Deposits as instruments to smooth cash flow peaks. Interest earned on investments in 2004/05 amounted to an estimated R1,7 billion, R200 million above budget. Interest revenue is projected to average R1,5 billion per year over the MTEF period.

Figure 5.4 Monthly gross surplus/deficit before borrowing



Non-interest bearing investments down to R50 million

Continuous improvements in cash management have reduced Government's daily non-interest bearing liquidity buffer with the Reserve Bank from R100 million to R50 million. Expected monthly cash flow requirements for 2005/06 are shown in figure 5.4. Peaks arise from seasonally high expenditure in April and interest payments in August and February. The repayment of the R152 bond, totalling R26,0 billion, will further increase the cash requirement in February.

Restructuring of state owned entities

Focus on improving performance of SOEs

The restructuring of state owned entities is coordinated by the Ministry of Public Enterprises, within the context of the Policy Framework on the Restructuring of State Assets and the National Framework Agreement. Over the past year the emphasis has been on improving financial performance, enhancing shareholder value, improving service delivery and operational efficiencies of state owned entities. Government's focus includes the contribution that the state owned entities can make to delivering infrastructure to enhance economic growth and alleviate poverty. Proceeds of R13,3 million were received from the sale of Aventura Resorts in 2004/05. Proceeds from the restructuring of state owned entities since 1997 amount to R33,7 billion, of which R24,8 billion was paid to the fiscus, as summarised in table 5.18.

Table 5.18 Proceeds from the restructuring of state owned entities since 1997 as at 31 January 2005

Proceeds R million	Total	Paid into the National Revenue Fund
TELKOM	10 360	5 894
SASRIA	10 300	9 300
MTN	7 700	5 697
Central Energy Fund	1 930	1 654
Airports Company	1 035	1 035
South African Airways	1 400	611
Others (SAFCOL, Aventura, radio stations, etc.)	961	640
Total	**33 686**	**24 831**

Initiatives currently in progress to enhance shareholder value include an assessment of treasury operations of state owned entities, a review of the mandates of development finance institutions and a review of financial distribution and capital structure policies of state owned entities. These reviews are conducted in cooperation with the relevant Executive Authorities.

Review of governance framework of non-business entities

The total number of public entities currently listed in terms of the PFMA stands at 276. During the past year, 11 public entities were listed, 8 de-listed and 3 underwent name changes. Noting the growth in the number and diversity of public entities, and inconsistencies in approaches to governance, remuneration, financial management and organisational structure, the Department of Public Service and Administration and National Treasury have undertaken a review of the governance of non-business public entities beginning in August 2003. Its findings include a new classification framework to distinguish entities governed by public law from those operating within the ambit of private law as companies or non-profit organisations. The findings also cover recommended corporate governance principles, procurement, human resource and performance management practices, and may in due course lead to amendments to both the Public Finance Management Act and the Public Service Act.