5

Asset and liability management

Sound macroeconomic policy and fiscal management have played a central role in building South Africa's reputation as a credible and competitive borrower. The approach to debt management has also helped to develop the financial sector as a source of capital for the public and private sectors. Improved access to capital and the development of specialised debt instruments for private borrowers have given a boost to domestic economic activity.

The fiscus has directly benefited from declining debt service costs, which have freed additional resources for social expenditure. In 1998, for each rand of revenue collected, government spent 24 cents to service debt; by 2005 only 14 cents of every rand were spent on debt service – and this will decrease to 10 cents per rand by 2009. Careful management of debt stock also contributes to an improved international position and a more stable exchange rate over time.

Government's net borrowing requirement for 2005/06 was R43,2 billion lower than projected. Net government debt as a percentage of GDP is expected to decline over the medium term to 27,7 per cent. Foreign debt as a percentage of total gross debt remains low at 13,4 per cent.

Financing government's borrowing requirement at the lowest cost within acceptable levels of risk will remain a central priority in the period ahead. New emphasis will be placed on improving the financial performance and corporate governance of state-owned entities, enabling them to better contribute to the development of the country's infrastructure base and to economic growth.

All three major rating agencies upgraded South Africa's sovereign debt status during the course of 2005. This translates into a lower risk premium on South African investments and further reduces borrowing costs.

Overview

Low debt level contributes to financial sustainability

Government has worked to place the management of national debt on a sound footing, and as a result, debt service costs have been driven down sharply. Debt as a percentage of GDP has reached historic lows, increasing the financial sustainability of the economy in coming years. This has contributed directly to an improved credit rating, enhancing South Africa's ability to borrow competitively in capital markets at lower rates of interest.

The decision by all three major rating agencies to upgrade South Africa's sovereign credit rating in 2005 reflects substantial progress in improving the country's competitiveness as an investment destination. Further upgrades are expected as the level of official foreign exchange reserves increases and urgent social challenges such as unemployment, poverty, HIV and AIDS, and income inequality are addressed.

International participation in domestic capital market is growing

With a stable economic environment and sophisticated financial markets, South Africa is one of a small group of countries that can finance its total borrowing requirement in the domestic market. The depth of the market, low transaction costs and a thriving secondary market have increased the attractiveness of South African assets to international investors. International participation in the domestic capital market continues to grow.

Government's debt policy emphasises further reductions in the cost of servicing debt, and concomitant increases in additional resources for economic development and poverty relief.

Prudent debt management has also contributed to deeper and healthier capital and financial markets. The successful issuance of very long-term government bonds signals strong positive sentiment about the long-term future of the economy, and reflects a fundamental shift in the financing options available to South African business. The market-deepening impact of this policy is demonstrated by the expansion of the corporate bond market in recent years.

Focus on financial performance and governance of state-owned entities

The restructuring of state-owned entities over the past decade generated proceeds that were used to reduce borrowing requirements and state debt. In the period ahead, government will work to improve financial performance and corporate governance at these entities, enabling them to make a larger contribution to economic development through infrastructure investment.

In 2006/07, government intends to fund its R24,7 billion borrowing requirement through two new fixed-income bonds, US$1 billion equivalent borrowing in international capital markets, and repurchase and reverse repurchase transactions, taking sound risk management principles into account.

This chapter provides a summary of asset and liability management activities for 2005/06, describes the funding proposal for 2006/07 and reviews the debt portfolio.

Developments in South Africa's debt markets

Domestic bond market developments

Yields on government bonds continued to fall

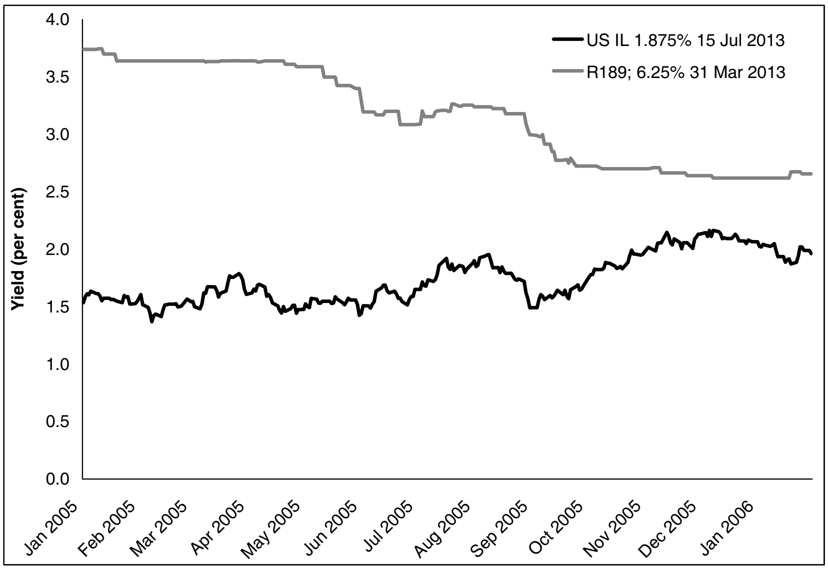
In a global environment characterised by relatively low interest rates and subdued inflation in major world markets, the yields on government bonds continued to fall in 2005 and into 2006. From a comparative perspective, as demonstrated in the difference in yield, South Africa's cost of capital has fallen to a level closer to that enjoyed by developed economies.

Domestic nominal bond yields reached historic low levels on 16 January 2006, with the yield on the R186 (10,5%; 2025/26/27) falling to 6,97 per cent. Demand for inflation-linked bonds grew during 2005/06, with the real yields on the R198 (3,8%; 2008) and the R189 (6,25%; 2013) bonds declining to all-time lows of 2,2 and 2,6 per cent respectively, from 3,5 and 3,7 per cent in 2004.

Interest rate differential between US, South African bonds narrows

The decline in yields also reduced the real interest rate differential between South African and equivalent US bonds from a high of 220 basis points in January 2005 to a historic low of 45 basis points in December 2005, as illustrated in Figure 5.1.

Figure 5.1 Comparisons of real yields (US vs. RSA), 2005



Turnover on Bond Exchange of South Africa declined marginally

Participation by international investors in the domestic bond market grew from below 11 per cent in 2003 to more than 16,4 per cent in 2005, reflecting positive global sentiment about the South African economy. As a result of the relative attractiveness of equity investments compared to bonds, turnover on the Bond Exchange of South Africa declined marginally, from R8,4 trillion in 2004 to R8,1 trillion in 2005.

Strong growth in corporate bonds

The corporate bond market continues to develop rapidly. Corporate bonds of about R50 billion were issued in 2005, including securitised issues and R30 billion worth of commercial paper. Trading remained relatively low due to the "buy-and-hold" approach of many investors, but as the market continues to grow, turnover is expected to rise and transaction costs to decline. The corporate bond market also experienced further innovation with the first bond listing by a non-resident bank and the first securitisation of residential mortgages.

Turnover increases in municipal bond market

Turnover in municipal bonds increased from R13 billion in 2004 to R21 billion in 2005 as investors diversified. Municipal bonds are not underwritten by government guarantees. The development of the municipal bond market was given further impetus by the decline in government bond issuance and low bond yields.

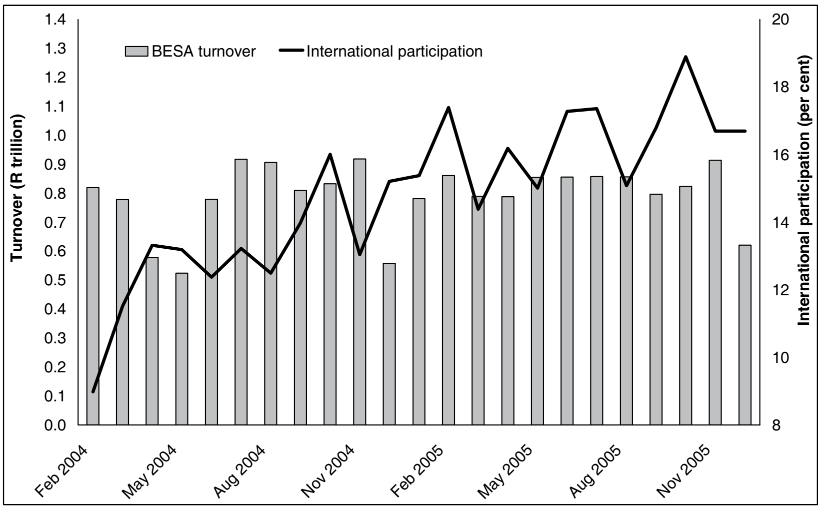
Liquidity levels – reflected by turnover ratios (Table 5.1) in domestic bonds – are high, and spread across the yield curve, including the longer-term R186 bonds. This compares favourably with liquidity in larger developed-economy bond markets.

Table 5.1 Turnover in domestic bonds, 2003 – 2005

Bond	2003	2004	2005
Times		Turnover ratio[1]	
Fixed-income			
R153 (13%; 2009/10/11)	*33,5*	*28,4*	*32,1*
R157 (13,5%; 2014/15/16)	*19,9*	*19,5*	*25,2*
R186 (10,5%; 2025/26/27)	*10,3*	*9,5*	*10,8*
R194 (10%; 2007/08/09)	*26,7*	*26,9*	*18,8*
R201 (8,75%; 2014)	*4,9*	*12,7*	*7,7*
R203 (8,25%; 2017)	–	*13,6*	*16,1*
R204 (8%; 2018)	–	*10,5*	*17,8*
R206 (7,5%; 2014)	–	–	*8,5*
R207 (7,25%; 2020)	–	–	*6,4*
Inflation-linked			
R189 (6,25%; 2013)	*0,9*	*0,6*	*0,6*
R197 (5,5%; 2023)	*2,3*	*0,7*	*0,8*
R198 (3,8%; 2008)	*3,7*	*3,8*	*8,1*
R202 (3,45%; 2033)	*7,2*	*3,4*	*1,8*

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

Figure 5.2 BESA turnover and international participation in the domestic bond market, 2004 and 2005



Issuance in international capital markets

Net foreign loan issuance was revised downwards

Net foreign loan issuance was revised downwards, from a planned R12 billion to R0,7 billion, as strong revenue growth reduced government's need to borrow in international capital markets in 2005/06.

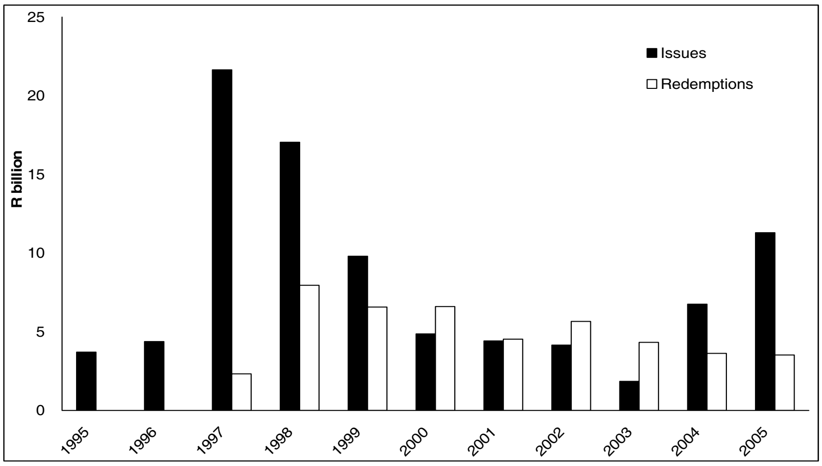
In January 2005, Moody's upgraded South Africa from Baa2 to Baa1. In August, both S&P and Fitch Ratings followed with upgrades from BBB to BBB+, the top notch of the BBB ratings. The improved sovereign credit ratings had a positive effect on South Africa's risk spreads relative to other emerging markets, which translate into lower borrowing costs on the global capital markets. Growing confidence in South Africa is evident in the performance of foreign currency denominated bonds as shown in Table 5.2.

Table 5.2 Performance of foreign bonds[1]

Bond	Coupon	Issue date	Maturity date	Issue spread	Average spread for 2005
R million	%			bps[2]	bps[2]
United States dollar					
300	*8,375*	*October 1996*	*October 2006*	*195*	*56*
1 500	*9,125*	*May 1999*	*May 2009*	*362/275*[3]	*86*
1 000	*7,375*	*April 2002*	*April 2012*	*240*	*97*
1 000	*6,500*	*June 2004*	*June 2014*	*195*	*96*
500	*8,500*	*June 1997*	*June 2017*	*183*	*108*
Euro					
500	*6,750*	*May 1999*	*May 2006*	*328*	*29*
500	*7,000*	*April 2001*	*April 2008*	*272*	*45*
1 250	*5,250*	*May 2003*	*May 2013*	*142*	*82*

1. Excluding three yen-bonds, since these bonds are held by buy-and-hold investors and are therefore not trading.
2. Spreads (percentages) are quoted relative to underlying international benchmark bonds. One basis point (bp) is 0,01 of a per cent.
3. This bond was issued at 362 bps over the US Treasury bond in 1999 and was reopened in 2000 at a spread of 275 bps over the US Treasury.

Figure 5.3 Eurorand bond market issues and redemptions, 1995 – 2005



The eurorand bond market

Robust demand for eurorand bonds broadens

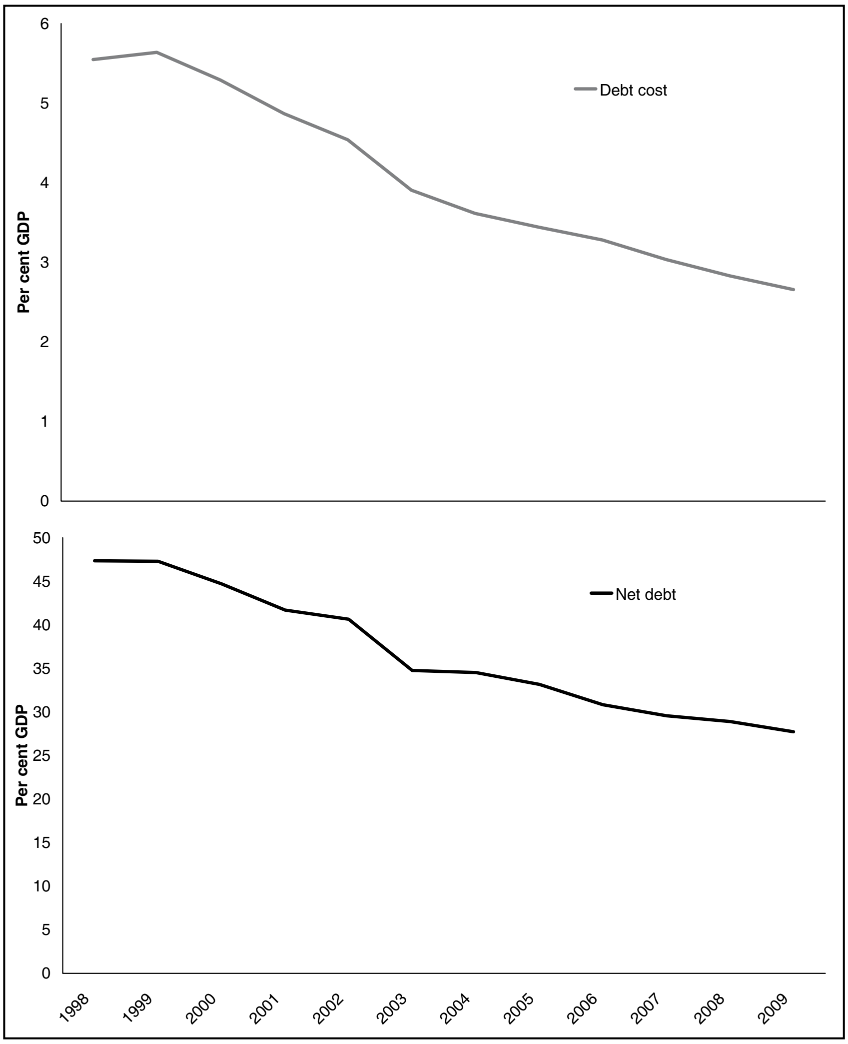
The issuance of eurorand bonds increased from R6,8 billion in 2004 to R11,3 billion in 2005. On a net basis, issuance increased from just over R3,1 billion to R7,8 billion, with maturities ranging from 2 to 20 years. A variety of issuers were involved in this market, which was dominated by the main multilateral development finance institutions. Robust demand for these bonds and a relatively stable currency have increased the number of foreign borrowers considering issuing rand-denominated debt. Increased demand for eurorand bonds is a strong signal of confidence in the South African economy, and contributes positively to raising capital in rand.

Snapshot of national government debt in 2005/06

Net borrowing requirement estimated at R10,3 billion in 2005/06

Government's net borrowing requirement for 2005/06 is estimated at R10,3 billion. This is R43,2 billion lower than the projection made in the 2005 Budget as a result of a lower budget deficit and higher extraordinary receipts, and despite prepayment of realised losses on the gold and foreign exchange contingency reserve account, and prepayment of the Saambou Bank liability.

Figure 5.4 Net debt and debt service cost declining, 1998 – 2009[1]



1. *The values for 2006 -2009 are forecasts.*

Two new single maturity fixed-income bonds were introduced

Two new single maturity fixed-income bonds, the R206 (7,5%; 2014) and the R207 (7,25%; 2020), were introduced in the domestic market, and R3,2 billion and R6,1 billion of these bonds were issued respectively. Total issuance of government retail bonds is expected to rise by R500 million to a total of R1,8 billion in 2005/06. Gross government debt is estimated at R533,9 billion. Taking into account cash balances of R52,9 billion, net government debt amounts to R481 billion. This is equivalent to 30,8 per cent of GDP, down from a high of 48,1 per cent of GDP in 1996/97. Foreign debt is 13,4 per cent of total gross debt, or 4,6 per cent of GDP.

State debt costs continue to decline as a result of prudent cash and debt management policies, and a stable macroeconomic environment. The cost of servicing government's debt is estimated to be R51,2 billion, a saving of R2 billion against budget. State debt costs as a percentage of GDP declined to 3,3 per cent from 3,4 per cent in 2004/05.

State debt costs declined to 3,3 per cent of GDP

Borrowing requirement

The net amount government needs to borrow is the sum of the main budget deficit, extraordinary receipts and extraordinary payments. Table 5.3 sets out the net borrowing requirements for 2004/05, a revised estimate for 2005/06 and estimates for the period ahead.

In 2005/06 the net borrowing requirement is expected to amount to R10,3 billion, increasing to an annual average of R24,4 billion over the next three years.

Table 5.3 Net borrowing requirement, 2004/05 – 2008/09

	2004/05	2005/06		2006/07	2007/08	2008/09
R million	**Outcome**	**Budget**	**Revised**	**Medium-term estimates**		
Budget deficit	20 687	47 950	7 891	26 363	27 171	24 177
Extraordinary receipts	-2 492	-1 529	-6 497	-1 700	-1 450	-1 450
Premiums on loan transactions [1]	*-2 464*	*-503*	*-2 000*	*-1 500*	*-1 200*	*-1 200*
Restructuring proceeds	*-28*	–	–	–	–	–
Special dividends	–	–	*-1 697*	–	–	–
Agricultural Debt Account surrender	–	*-1 026*	*-150*	*-200*	*-250*	*-250*
Foreign Exchange amnesty proceeds	–	–	*-2 650*	–	–	–
Extraordinary payments	9 787	7 000	8 871	–	–	–
Premiums on loan transactions [1]	*326*	–	–	–	–	–
Defrayal of GFECRA losses [2]	*9 461*	*7 000*	*4 539*	–	–	–
Saambou Bank liability	–	–	*4 332*	–	–	–
Total	**27 982**	**53 421**	**10 265**	**24 663**	**25 721**	**22 727**

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.

Extraordinary receipts

In 2005/06, provision was made for extraordinary receipts of R1,5 billion, composed of premiums of R503 million on bonds issued to finance the borrowing requirement, and the transfer of R1 billion from the agricultural debt account held at the Corporation for Public Deposits to the National Revenue Fund. Extraordinary receipts are expected to increase by R5 billion to R6,5 billion due to higher premiums on loan issues, foreign exchange amnesty proceeds previously provided for under departmental revenue, and special dividends from Eskom and Telkom, partially offset by lower transfers

Extraordinary receipts of R6,5 billion in 2005/06 from the agricultural debt account at the Corporation for Public Deposits.

On average, R1,3 billion a year is provided for premiums on bond issues over the MTEF period. The amount will vary depending on the bonds issued and the absolute level of interest rates.

Extraordinary payments

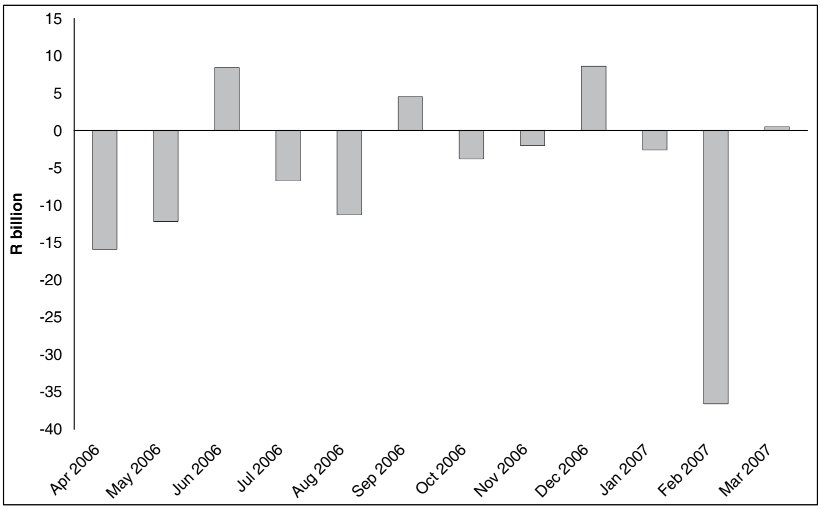
No extraordinary payments expected over the medium term

No extraordinary payments are expected over the medium term. Extraordinary payments in 2005/06 include R4,5 billion in bonds issued to the Reserve Bank in terms of the Gold and Foreign Exchange Contingency Reserve Account Defrayal Act (2003). This is R2,5 billion lower than budgeted due to advances to the Reserve Bank in 2004/05. The liability of R4,3 billion relating to Saambou Bank originally expected to be paid in 2007/08 will be settled in 2005/06.

Monthly borrowing requirements

Expected monthly cash flow requirements for 2006/07 are shown in Figure 5.5, which indicates seasonally high expenditure in April and interest payments in August and February. The redemption of the first maturity tranche of the R194 (10%; 2007/08/09) bond, totalling R22,6 billion, will require further cash in February 2007.

Figure 5.5 Monthly gross surplus/deficit before borrowing, 2006/07[1]



1. The values for 2006/07 are forecasts.

Financing of the borrowing requirement

Table 5.4 provides information on the funding of government's net borrowing requirement for 2004/05, revised estimates for 2005/06, and projections for 2006/07 to 2008/09.

Table 5.4 Financing of net borrowing requirement, 2004/05 – 2008/09

	2004/05	2005/06		2006/07	2007/08	2008/09
R million	**Outcome**	**Budget**	**Revised**	**Medium-term estimates**		
Domestic short-term loans (net)	6 132	4 974	5 850	5 800	5 750	5 750
Treasury bills	*6 000*	*6 000*	*6 000*	*6 000*	*6 000*	*6 000*
Corporation for Public Deposits	*132*	*-1 026*	*-150*	*-200*	*-250*	*-250*
Domestic long-term loans (net)	33 409	25 768	23 306	8 694	16 529	22 996
Market loans	*50 300*	*45 140*	*45 141*	*44 500*	*47 000*	*48 000*
Extraordinary issues	*9 461*	*7 000*	*4 539*	–	–	–
Redemptions	*-26 352*	*-26 372*	*-26 374*	*-35 806*	*-30 471*	*-25 004*
Foreign loans (net)	4 538	12 039	742	2 415	3 638	2 362
Market loans	*6 404*	*9 390*	–	*6 227*	*6 836*	*7 872*
Arms procurement loan agreements	*3 407*	*4 708*	*3 164*	*3 569*	*2 940*	*2 139*
World Bank loans [1]	*62*	–	*50*	*13*	*14*	*8*
Redemptions (including revaluation of loans)	*-5 335*	*-2 059*	*-2 472*	*-7 394*	*-6 152*	*-7 657*
Change in cash and other balances [2]	-16 097	10 640	-19 633	7 754	-196	-8 381
Opening balance	14 773	20 640	33 278	54 411	48 157	49 853
Cash balance	*12 669*	*19 140*	*30 870*	*52 911*	*46 657*	*48 353*
Surrenders/late requests	*1 922*	*1 500*	*2 408*	*1 500*	*1 500*	*1 500*
Cash flow adjustment [3]	*182*	–	–	–	–	–
Closing balance	-30 870	-10 000	-52 911	-46 657	-48 353	-58 234
Sterilisation deposits [4]	–	–	*-36 000*	*-37 600*	*-39 300*	*-41 100*
Operational cash	*-30 870*	*-10 000*	*-16 911*	*-9 057*	*-9 053*	*-17 134*
Total [5]	**27 982**	**53 421**	**10 265**	**24 663**	**25 721**	**22 727**

1. Loans to provide financial and technical support for the municipal financial management project.
2. A positive change indicates a reduction in cash balances.
3. Represents a reconciliation of actual revenue and actual expenditure against National Revenue Fund flows.
4. Deposits made with the Reserve Bank to regulate internal monetary conditions as provided for in Section 71(e) of the PFMA. See sterilising excess money market liquidity box.
5. Full details are reflected in Table 1 of Annexure B.

Total loan redemptions were R415 million higher than expected

The net borrowing requirement excludes loan redemptions, which also need to be financed. The scheduled loan redemptions for 2004/05 and 2005/06 and medium-term estimates are set out in Table 5.5. Total loan redemptions amounted to R28,8 billion in 2005/06, R415 million more than anticipated. This is mainly due to the net impact of the prepayment of a US$89 million arms procurement loan (R653 million) and a lower rand value of foreign loan redemptions due to the stronger currency (R240 million). Government's borrowing requirement is financed through domestic short- and long-term loans, foreign loans and changes in cash balances.

Domestic short-term loans

Short-term loans up R5,9 billion

Short-term borrowing in the domestic market consists of treasury bill issuances and borrowing from the Corporation for Public Deposits. In 2005/06 short-term loans increased by a net R5,9 billion, with a slightly lower average yield than budgeted of 6,8 per cent. To develop the treasury bill yield curve, the range of 3- and 6-month treasury bills was extended to include 9-month bills.

Table 5.5 Loan redemptions, 2004/05 – 2008/09

	2004/05	2005/06		2006/07	2007/08	2008/09
R million	Outcome	Budget	Revised	Medium-term estimates		
Domestic loans	26 352	26 372	26 374	35 806	30 471	25 004
Foreign loans	5 335	2 059	2 472	7 394	6 153	7 657
Principal	*4 039*	*1 311*	*1 964*	*6 004*	*5 531*	*5 204*
Revaluation	*1 296*	*748*	*508*	*1 390*	*622*	*2 453*
Total	**31 687**	**28 431**	**28 846**	**43 200**	**36 624**	**32 661**
Excludes:						
Source bonds in switch auctions	*16 771*	*7 000*	*4 539*	–	–	–

Stock of treasury bills to increase by R6 billion a year over medium term

From 2006/07 to 2008/09, the stock of treasury bills will annually increase by R6 billion, with issuance spread over all maturities. Treasury bills of one month and shorter maturities will be considered for bridging finance purposes.

Borrowing from the Corporation for Public Deposits will decrease by R150 million in 2005/06, and by R700 million over the next three years, due to a transfer from the agricultural debt account to the exchequer account. Borrowing from the corporation in 2006/07 will be for bridging finance purposes and to sterilise the money market impact of flows on government's accounts.

Domestic long-term loans

2005/06 domestic long-term loan issuance will remain at R45,1 billion

Despite revenue overruns, the 2005/06 domestic long-term loan issuance to the market will remain at the budgeted level of R45,1 billion. This is done to pre-fund the borrowing requirement for 2006/07. Bond issuance to the Reserve Bank in terms of the Gold and Foreign Exchange Contingency Reserve Account Defrayal Act decreased to R4,5 billion from an originally expected R7 billion.

Table 5.6 provides a breakdown of the R37,8 billion in government bonds issued for the purposes of financing in 2005/06 up to 31 January 2006. Fixed-income bonds remain the major source of financing, constituting 71,3 per cent of total issuance, while inflation-linked bonds and floating rate notes account for 22,6 per cent and 6,1 per cent, respectively. Fixed-income bonds were issued at a weighted average yield of 8,1 per cent, while inflation-linked bonds were issued at a weighted average yield of 2,9 per cent.

The fixed-income bond issuances in 2005/06 were concentrated in the 10- to 19-year maturities. In line with government's objective of enhancing price discovery and efficiency in the bond market, 84,8 per cent of the fixed-income bond issuances were in single maturity bonds.

New 2021 and 2036 fixed-income bonds

In 2006/07, net domestic long-term bond issuance will be R8,7 billion, averaging R19,8 billion over the next two fiscal years. Issuance will be in the existing fixed-income benchmark bonds – the R153, R157, R186, R201, R203, R204, R206 and the R207. New fixed-income bonds in the 2021 and 2036 maturity areas will be introduced to spread issuance over the medium to long term, and to satisfy investor demand for very long-term bonds.

Table 5.6 Domestic bonds issued for financing, 2005/06

As at 31 January 2006 R million	Cash value	Average yield %
Fixed-income	26 982	8,07
R153 (13%; 2009/10/11)	*288*	*8,34*
R157 (13,5%; 2014/15/16)	*1 752*	*8,24*
R186 (10,5%; 2025/26/27)	*2 060*	*7,47*
R201 (8,75%; 2014)	*2 527*	*8,17*
R203 (8,25%; 2017)	*4 502*	*8,23*
R204 (8%; 2018)	*6 202*	*8,25*
R206 (7,5%; 2014)	*3 162*	*7,97*
R207 (7,25%; 2020)	*6 050*	*7,92*
Retail	*439*	*8,63*
Inflation-linked	8 532	2,89
R189 (6,25%;2013)	*3 578*	*2,96*
R197 (5,5%; 2023)	*2 511*	*2,89*
R198 (3,8%;2008)	*1 916*	*2,71*
R202 (3,45%; 2033)	*527*	*3,16*
Floating rate	2 300	
R205 (floating; 2012)	*2 300*	*6,88*
Total	**37 814**	

Growing demand for inflation-linked bonds

Demand for inflation-linked bonds by international fund managers and domestic pension funds continued to rise in 2005/06. The concentration of inflation-linked bond issuance was in the shorter-dated R189 and R198 bonds, which constituted 64,4 per cent of the total inflation-linked bond issuance, followed by longer-maturity R197 and R202 bonds.

No new floating rate note in 2006/07

Introduced in 2005, issuance of the R205 (2012) floating rate note was R2,3 billion up to 31 January 2006. No new floating rate notes will be introduced in 2006/07.

In 2005/06, sales of RSA retail bonds will contribute approximately R500 million to finance the borrowing requirement.

Switches of R4,5 billion were effected with Reserve Bank

The National Treasury allows the Reserve Bank to convert its current bond portfolio into cash or short-term interest-bearing instruments. Switches of R4,5 billion were effected with the Reserve Bank in 2005/06. The nominal value of government's debt portfolio declined by R273 million due to these transactions.

In 2006/07 government will enter into repurchase and reverse repurchase bond transactions. These will be used to provide bridging finance for the National Revenue Fund, to enhance efficiency of the primary and secondary inflation-linked bond markets, to optimise returns on investments and to manage investment counter-party risk.

Foreign loans

Capital market loan was shelved due to lower borrowing requirement

Foreign loan issues as at 31 January 2006 are set out in Table 5.7. In 2005/06, provision was made for foreign capital market loans equivalent to US$1,5 billion (R9,4 billion) and US$752 million (R4,7 billion) for arms procurement. The capital market loan was shelved due to a lower borrowing requirement. To date, R2,9 billion has been borrowed. A further R300 million will be drawn on the arms procurement loan agreements.

Table 5.7 Foreign loan issues, 2005/06

As at 31 January 2006 R million	
Market loans	–
Concessionary: World Bank Loan	43
Arms procurement loan agreements	2 821
AKA-Commerzbank (Submarines)	*820*
AKA-Commerzbank (Corvettes)	*5*
Societe Generale (Corvettes)	*211*
Mediocredito Centrale (Light utility helicopters)	*99*
Barclays (Hawk / Gripen)	*1 686*
Total	**2 864**

Government has also drawn R43 million on a World Bank loan facility to provide technical support for the municipal financial management project.

US$1 billion equivalent will be borrowed to cover maturing foreign debt

In 2006/07, the equivalent of US$1 billion will be borrowed in the international market to cover maturing foreign debt. Including the disbursements on arms procurement loan agreements and the World Bank loan, government will raise the equivalent of US$1,6 billion, US$1,4 billion and US$1,3 billion over the MTEF period.

Cash balances

Higher opening cash balance due to revenue overruns

For 2005/06, the opening cash balance in accounts with the Reserve Bank, and the tax and loan accounts with commercial banks, amounted to R33,3 billion against a budgeted amount of R20,6 billion. The higher opening balance is due to revenue overruns in 2004/05 and the net of R2,4 billion surrenders and late requests by departments.

In 2005 government drew on its cash deposits with commercial banks for deposit in an interest-bearing account with the Reserve Bank. This contributes to the resources available to the Reserve Bank to "sterilise" the excess cash created in the money market when purchasing foreign exchange reserves. The sterilisation deposits with the Reserve Bank are not available to finance government's borrowing requirement, as this would increase the money supply.

On 31 March 2006, sterilisation deposits are projected to be R36 billion, increasing to R41,1 billion in 2009 as a result of capitalised interest. In addition, cash balances for operational purposes (cash excluding sterilisation deposits) are projected to be R16,9 billion, bringing total cash balances to R52,9 billion at the end of 2005/06.

Cash balances will be reduced to finance borrowing

In 2006/07, operational cash balances will be reduced by R7,8 billion to finance part of the borrowing requirement. These balances are expected to average R9,1 billion over the next two years, increasing to R17,1 billion in 2008/09.

Government's surplus cash is invested in the tax and loan accounts with commercial banks and special investment accounts at the Reserve Bank. For 2005/06, interest earned is estimated at R2,2 billion, which is R0,6 billion higher than in 2004/05. It is estimated that interest earned will further increase to average R3,1 billion over the medium term, largely due to the sterilisation deposit.

Sterilising excess money market liquidity

South Africa has historically had a weak international liquidity position, reflected by a negative net open foreign currency position (NOFP). This resulted in external vulnerability, which was partly responsible for the volatility in the financial markets and capital flows. Periodic and severe weakness in the currency fed through into inflation, forcing interest rates up and preventing foreign investment. Rating agencies raised concerns about external creditworthiness and susceptibility to shocks.

To improve macroeconomic stability and lower the cost of capital, government and the Reserve Bank agreed to eliminate the NOFP and improve the level of official reserves. By 2004/05, net official reserves had increased to US$12,4 billion from a negative position of US$23,2 billion in 1998.

Further increases in reserves were difficult to achieve because of the impact on cash levels in the banking sector and money market. To add to reserve levels over the past year, the National Treasury helped "sterilise" excess cash by drawing R36 billion from its deposits with commercial banks and holding these balances in an interest-bearing sterilisation account with the Reserve Bank. This enabled a further increase in net official reserves to US$18,7 billion in January 2006.

The higher level of reserves has led to greater domestic and international confidence in macroeconomic policy and has reduced external vulnerability. The cost of capital has continued to decline, and the sovereign credit rating has reached the top notch of the investment-grade BBB ratings. Improved stability has contributed directly and indirectly to South Africa's present sustained economic expansion and buoyant government revenue.

Size and structure of government's debt portfolio

Total debt

The increase in net loan debt of R10,1 billion since 31 March 2005 is explained in Table 5.8.

Table 5.8 Increase in government debt, 2005/06

R million	
Financing of net borrowing requirement (net of change in cash balances)	29 898
Discount on new loans	806
Revaluation of foreign debt portfolio	1 404
Increase in gross loan debt	**32 108**
Change in cash balances at bank[1]	-22 041
Increase in net loan debt	**10 067**

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

After taking into account the bank balances of the National Revenue Fund, total net loan debt is anticipated to be R481 billion at the end of March 2006, and average R544,4 billion over the MTEF.

Net loan debt as percentage of GDP decreases

The composition of government debt for the period 2002/03 to 2008/09 is summarised in Table 5.9. Net loan debt decreased to a projected 30,8 per cent of GDP at the end of 2005/06, from 33,2 per cent at the end of 2004/05. Based on current projections of borrowing requirements, interest rates and exchange rates, total net loan debt as a percentage of GDP is expected to continue to decrease, averaging 28,7 per cent over the next three years.

Table 5.9 Total government debt, 2002/03 – 2008/09

End of period	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
R billion		Outcome		Estimate		Medium-term estimates	
Domestic debt	351,9	390,5	432,4	462,3	477,8	502,0	532,2
Foreign debt[1]	74,3	64,7	69,4	71,6	76,0	91,1	107,4
Gross loan debt	**426,2**	**455,2**	**501,8**	**533,9**	**553,8**	**593,1**	**639,6**
Less: National Revenue Fund bank balances	-9,7	-12,7	-30,9	-52,9	-46,7	-48,4	-58,2
Net loan debt[2]	**416,5**	**442,5**	**470,9**	**481,0**	**507,1**	**544,7**	**581,4**
As percentage of GDP :							
Net loan debt	*34,8*	*34,5*	*33,2*	*30,8*	*29,6*	*28,9*	*27,7*
Foreign debt	*6,2*	*5,0*	*4,9*	*4,6*	*4,4*	*4,8*	*5,1*
As percentage of gross loan debt:							
Foreign debt	*17,4*	*14,2*	*13,8*	*13,4*	*13,7*	*15,4*	*16,8*

1. *Forward estimates are based on National Treasury's projections of exchange rates.*
2. *Net 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).*

Foreign debt falls to 4,6 per cent of GDP in 2005/06 rising to 5,1 in outer year

Over the same period, foreign debt as a percentage of GDP is estimated to increase to 5,1 per cent. Foreign debt as a percentage of gross loan debt will increase to 16,8 per cent. A more comprehensive picture of government debt since 1995/96 is provided in Table 8 of Annexure B.

Maturity and composition of government debt

Moderate decrease in maturity of domestic debt

The average maturity and duration of domestic marketable bonds is reflected in Table 5.10. The average maturity has decreased from 8,1 years in 2004/05 to 8 years in 2005/06. The weighted average term (duration) of interest and redemption cash flows has increased from 5,2 years for 2004/05 to 5,3 years for 2005/06. This can be attributed to the issuance of more medium- and long-term bonds and the growing prevalence of inflation-linked bonds.

Table 5.10 Maturity distribution of domestic marketable bonds, 2003/04 – 2005/06

Years	2003/04	2004/05	2005/06 Estimates	
Percentage of total	Portfolio		Funding	Portfolio
0 – 3	21.6	22.2	4.7	22.0
3 – 7	33.6	32.7	8.1	25.3
7 – 10	13.4	16.9	29.7	24.3
10 – 19	19.5	18.8	50.5	18.8
Longer than 19	11.9	9.4	7.0	9.6
Years				
Average duration[1]	4.9	5.2	7.3	5.3
Average maturity	8.1	8.1	11.2	8.0

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

The composition of domestic debt, categorised by instrument, is displayed in Table 5.11.

Table 5.11 Composition of domestic debt by instrument, 2002/03 – 2005/06

End of period R billion	2002/03	2003/04 Outcome	2004/05	2005/06 Estimate
Bonds	327,9	360,0	395,8	419,9
Fixed-income	*299,4*	*314,9*	*338,7*	*350,8*
Floating rate	*0,6*	*7,6*	*8,8*	*11,5*
Zero coupon	*2,3*	*2,3*	*2,3*	*2,2*
Inflation-linked	*25,6*	*35,2*	*44,7*	*53,6*
Retail	–	–	*1,3*	*1,8*
Treasury bills	23,3	29,9	36,1	42,0
Shorter than 91-days[1]	*1,2*	*1,3*	*1,6*	*1,5*
91-days	*17,0*	*23,4*	*29,3*	*28,0*
182-days	*5,1*	*5,2*	*5,2*	*7,8*
273-days	–	–	–	*4,7*
Other[2]	0,7	0,6	0,5	0,4
Total	**351,9**	**390,5**	**432,4**	**462,3**

1. Mainly 1-day bills issued to the Corporation for Public Deposits.
2. Loan levies, former regional authorities and Namibian debt.

Fixed-income bonds to make up 75,9 per cent of domestic debt

By the end of 2005/06, fixed-income bonds are expected to comprise 75,9 per cent, floating rate bonds 2,5 per cent and inflation-linked bonds 11,6 per cent of the total domestic debt. Treasury bills will constitute 9,1 per cent of total domestic debt, with 3-month bills representing 66,7 per cent of total treasury bills.

Decline in US dollar debt

A currency breakdown of foreign debt obligations from 2002/03 is set out in Table 5.12. Among other things, it indicates a decline in US dollar borrowing from a high of 54,2 per cent in 2002/03 to an estimated 44,2 per cent in 2005/06.

Table 5.12 Currency breakdown of foreign debt, 2002/03 – 2005/06

End of period Percentage of total	2002/03	2003/04	2004/05	2005/06 Estimate
Euro	28,2	44,6	42,7	41,1
United States dollar	54,2	36,4	43,1	44,2
Japanese yen	14,6	15,3	10,2	9,5
British pound	2,1	2,6	2,7	2,7
Swedish krone	0,5	0,6	0,7	1,7
Gold	0,4	0,5	0,6	0,8

Contingent liabilities

Contingent liabilities of R157,9 billion are disclosed in the consolidated financial statements of national government as at 31 March 2005. This information is summarised in Table 5.13.

A guarantees certification committee, made up of officials from the National Treasury, manages the granting of borrowing powers to general government bodies and the issuing of guarantees to state-owned entities. The committee's mandate has been broadened to include all other contingent liabilities that may affect the budget. This committee reviews financial and other risk exposures before making a recommendation to the Minister of Finance.

Table 5.13 Composition of contingent liabilities, 2002/03 – 2004/05

End of period R billion	2002/03	2003/04	2004/05
Guarantees	69,4	78,1	76,0
Domestic	*47,2*	*58,8*	*57,2*
Foreign	*22,2*	*19,3*	*18,8*
Road Accident Fund	23,8	18,5	23,1
Post retirement medical assistance	14,3	37,0	37,0
Export Credit Insurance Corp. S.A. Ltd.	9,2	7,5	7,5
Government pension funds	3,0	3,0	3,0
SASRIA reinsurance cover	1,0	1,0	1,0
Unemployment Insurance Fund	1,3	2,5	2,5
Other[1]	0,1	7,5	7,8
Total	**122,1**	**155,1**	**157,9**

1. Mainly represents departmental commitments relating to capped leave.

New guarantees of R1,6 billion in 2005/06

Government's guarantee exposure in 2005/06 grew by R1,6 billion, of which R1,5 billion was issued to the Land Bank and R94 million to the Development Bank of Southern Africa.

Guarantee fees of R47,8 million were received from state-owned entities in 2005/06. Details of government's guarantee commitments are set out in Table 9 of Annexure B.

State debt cost

State debt cost is influenced by the volume of debt, new borrowing requirements, interest rates and the value of the currency. Trends and projections of state debt cost between 2004/05 and 2008/09 are set out in Table 5.14.

Table 5.14 State debt cost, 2004/05 – 2008/09

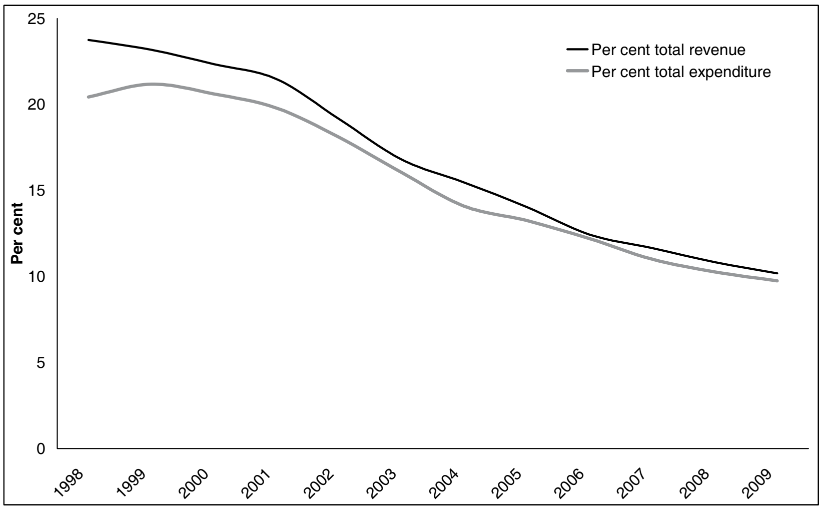
	2004/05	2005/06		2006/07	2007/08	2008/09
R million	Outcome	Budget	Revised	Medium-term estimates		
Domestic	44 576	47 714	46 699	47 366	47 811	49 067
Foreign	4 275	5 411	4 461	4 683	5 513	6 649
Total	**48 851**	**53 125**	**51 160**	**52 049**	**53 324**	**55 716**
State debt cost as percentage of :						
GDP	*3,4*	*3,5*	*3,3*	*3,0*	*2,8*	*2,7*
GDP-accrual [1]	*3,8*	*–*	*3,5*	*3,3*	*3,0*	*2,9*
Revenue	*14,0*	*14,4*	*12,5*	*11,7*	*10,8*	*10,2*

1. State debt cost adjusted for the amortisation of discount on bond issues and expressed as a percentage of GDP.

R2 billion saving in state debt cost

In 2005/06, state debt cost is estimated to be R2 billion lower than the budgeted amount of R53,1 billion, as a result of prudent debt management, lower borrowing requirements, lower interest rates and currency appreciation. State debt cost is estimated at R52 billion in 2006/07, increasing gradually at an average year-on-year rate of 3,5 per cent to R55,7 billion in 2008/09.

Figure 5.6 State debt cost continues to decline, 1998 – 2009 [1]



1. The values for 2006 – 2009 are forecasts.

State debt cost declining to 2,7 per cent of GDP

State debt cost as a percentage of GDP is projected to decline further to an historic low of 2,7 per cent in 2008/09 from 5,6 per cent in 1998/99. As a percentage of revenue and expenditure, debt service cost will fall to 10,2 and 9,8 per cent respectively by 2008/09. Measured as a percentage of expenditure, over the past nine years this decline in debt service costs has released significant additional resources for economic development and poverty relief, roughly equivalent to R100 billion.

The adjusted state debt cost ratios are also shown in Table 5.14. Net government debt on an accrual-adjusted basis is on average 3 per cent lower than the nominal aggregates over the medium term.

Asset management

State-owned entities are strategic drivers of economic growth and development

Government intends to improve the financial performance, operational efficiency and cost-effectiveness of service provision at state-owned entities. Over the past year the major state-owned enterprises have been focusing on their core functions and planning the disposal of non-core businesses. As strategic drivers of economic growth and development, these entities have begun to invest financial resources in key infrastructure projects that will attract higher levels of sustainable investment in the economy.

The National Treasury is conducting an assessment of the treasury operations of state-owned entities, reviewing the mandates of development finance institutions and evaluating policies relating to financial distribution and capital structures.

Risk management developments

Government has a comprehensive strategy to manage risk

As reported in the 2005 *Budget Review*, the National Treasury has widened the scope of risk management from a market risk analysis of the state's debt portfolio to a government-wide risk management approach. Substantial progress has been made in this regard.

Management of debt exposes government to market, liquidity, counterparty credit and operational risks. Market risk is managed through a balanced choice of fixed, floating and index-linked debt, and a preferred level and composition of foreign debt. Liquidity risk is actively managed through maintaining a smooth debt maturity profile and regularly updating forecasted cash flows. Credit risk related to investments is managed within approved limits. Social, economic and political factors that may affect South Africa's international credit rating are monitored. The risk associated with the issuing of financial guarantees by government is managed by establishing risk ratings for guaranteed counterparties.