5

Asset and liability management

Twelve years of prudent macroeconomic policy have contributed to a robust economy capable of both sustaining and accelerating the growth trajectory. The uniqueness of South Africa's economic landscape is reflected in the fact that government is increasing capital and socio-economic expenditure, even as it continues to enjoy a positive fiscal balance and is reducing the amount of money it needs to borrow.

South Africa's public finances do not centre on servicing debt, but on the essential pillars of human development – poverty reduction, health, education and job creation. Whereas a decade ago government spent 18 cents of every rand of expenditure servicing debt, this has decreased to 11 cents in 2007, and by 2009 the figure will fall to 8 cents. The decreasing debt cost and lower debt stock strengthens the domestic financial sector as a source of capital for both the public and private sector, as seen in higher turnover in the bond market.

To reduce external vulnerability, government continues to work with the Reserve Bank to improve the level of official reserves, which stood at US$25,9 billion at the end of January 2007. Financial stability has contributed to the cost of capital remaining at historically low levels, and the sovereign risk premium continues to fall. Efforts to improve financial performance and corporate governance of state-owned entities have begun to yield results.

Overview

South Africa's borrowing requirement continues to decline

As a result of sound economic policy and prudent management of the national debt portfolio, supported by increasing revenue from strong economic growth, South Africa's borrowing requirement continues to decline. The country's international credit ratings are improving, enabling government to borrow at more competitive rates in the global capital markets.

A lower borrowing requirement reduces government debt issuance in the market, providing the opportunity for state-owned entities and other companies to finance their operations at lower cost. In 2006/07 and over the next three years, government will in net terms buy back R6,6 billion of debt, compared to net borrowing of R78,6 billion over the preceding four years.

Lowering the debt burden on future generations

As a consequence of this, the debt burden on future generations continues to decline. Interest costs measured as a percentage of revenue and GDP have fallen to historically low levels as a result of a favourable interest rate outlook and lower debt stock. The combined effect of these trends is that additional resources can be made available for economic development and poverty relief.

The variance in fiscal results, as reflected in the projected budget surplus in 2006/07 and 2007/08 and modest budget deficits expected thereafter, poses new challenges and opportunities.

Debt management strategy seeks to enhance liquidity

Government's debt management strategy seeks to enhance liquidity in an environment of declining borrowing requirements. The foreign debt management strategy will focus on active debt management. With a view to decreasing sovereign external vulnerability, government continues to work with the Reserve Bank to increase official reserves.

To maintain the efficiency of the domestic capital market, the volumes of existing benchmark bonds will be increased and a new inflation-linked bond will be introduced. To alleviate the shortage of liquid assets in the money market, Treasury bill issuance will be increased.

Although South African financial markets were not immune from a broad-based emerging market sell-off in mid-2006, the impact on South Africa's foreign bonds was moderate in comparison with other emerging markets due to favourable economic fundamentals.

A concerted effort to improve financial performance of the state-owned entities

Government's initiatives to improve the financial performance and corporate governance of state-owned entities have begun to pay off through increased infrastructure investment, contributing to further economic development. The major public entities plan to invest about R152 billion in infrastructure development over the three-year expenditure period.

This chapter discusses developments in the domestic and international debt markets over the medium term, including government's borrowing requirement and the financing and risks thereof, the size and structure of government's debt portfolio, contingent liabilities and management of the state-owned enterprises.

Developments in South Africa's debt markets

Domestic bond market developments

South Africa's low bond yields contribute to lowering the cost of doing business in the country.

Government bond yields reach record low levels in 2006

Nominal yields on government bonds reached record lows in 2006/07. The R153 (13%; 2009/10/11) and R157 (13,5%; 2014/15/16) bonds traded as low as 7,05 per cent and 7,13 per cent respectively during February 2006. The stronger rand, benign inflation conditions, lower bond supplies and large cash flows emanating from redemptions and coupon payments during February 2006 underpinned demand for domestic bonds.

In June 2006, after three years of falling interest rates, the Reserve Bank announced a 50-basis-point increase in the repo rate, to 7,5 per cent. By mid-September bond yields had increased, on average, by about 160 basis points, with the R153 and R157 bonds trading at 8,81 per cent and 8,89 per cent respectively. These were the highest levels reached during 2006.

Yields increased in response to tightening of monetary policy

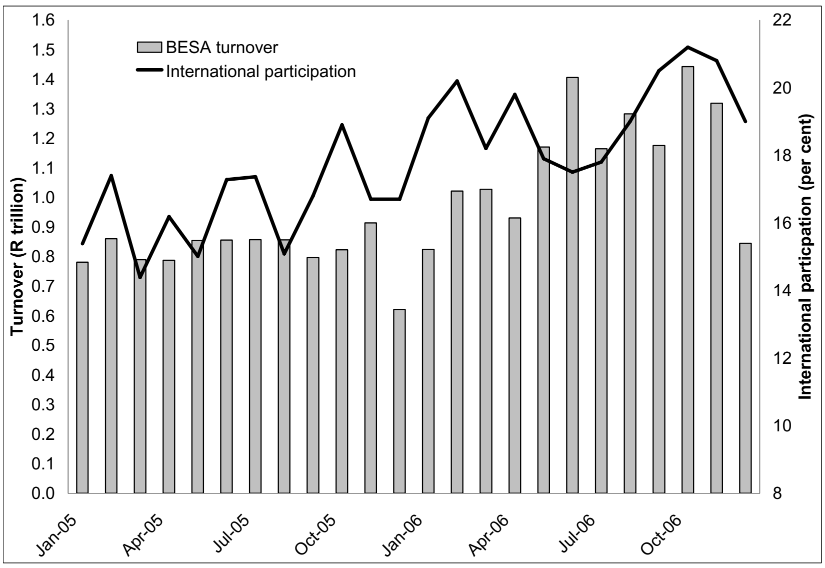
Despite a total increase of 200 basis points in the repo rate during the course of 2006, yields declined from their September peak owing to the appreciation of the rand during the fourth quarter, the impact of the 2006 *Medium Term Budget Policy Statement* – which indicated a decreasing bond supply – and expectations of lower inflation that emerged towards the end of the year. In addition, attractive macroeconomic conditions and the widening interest rate differentials between South African and international capital markets attracted international investors to the domestic bond market. By January 2007, the R157 bond was trading 129 basis points lower than the high reached in September 2006.

Bond market attracted substantial international investment in 2006

Although liquidity in inflation-linked bonds remained relatively low, yields still reflected changes in inflation expectations. A significant development during 2006/07 was the introduction of the inflation-linked bond reverse repurchase agreement (reverse repo) facility. The purpose of this facility is to enhance the liquidity of inflation-linked bonds as part of the development of the domestic capital market.

Reverse repo facility is introduced

Figure 5.1 Bond Exchange of South Africa turnover and international participation, 2005 and 2006



Turnover on the Bond Exchange of South Africa grew considerably during 2006, from R8,1 trillion in 2005 to R11,4 trillion, a 40,7 per cent increase. International investors showed an increased appetite for domestic bonds. Their participation increased from

Higher turnover and participation in domestic bonds

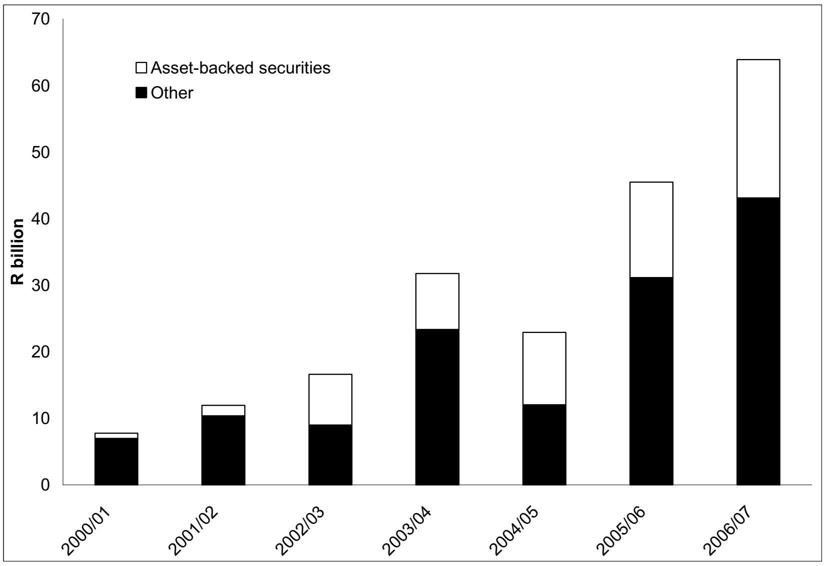
16,5 per cent in 2005 to about 20 per cent in 2006, when they purchased a net R34,1 billion in bonds, supported by favourable risk-return ratios.

South Africa's domestic bonds are also traded internationally by investors, especially through the Euroclear settlement agency, which provides settlement services to more than 30 bond markets. These numbers are not reflected in the reported turnover of the Bond Exchange of South Africa.

Corporate bond market continues to grow

The corporate bond market benefited from the decreasing cost of capital, allowing companies to issue a net amount of about R64 billion at favourable spreads during 2006, including borrowing of about R12 billion by state-owned enterprises.

Figure 5.2 Net corporate bond issuance, 2000/01-2006/07



Asset-backed securities are becoming increasingly popular. Figure 5.2 illustrates the growth of asset-backed securities in comparison with total net corporate bond issuance.

Lower turnover in municipal bonds

The City of Johannesburg continues to dominate the municipal bond market. Turnover in municipal bonds decreased from R21 billion in 2005 to R9 billion in 2006, mainly due to municipalities' preference for bank loans.

R153 and R157 bonds remain benchmarks

Table 5.1 shows a continued increase in the liquidity levels (turnover ratios) in domestic bonds. Turnover was heavily weighted towards the R153 and R157 bonds.

Table 5.1 Turnover in domestic bonds, 2004 – 2006

Bond	2004	2005	2006
Times		Turnover ratio[1]	
Fixed-income			
R153 (13%; 2009/10/11)	*28,4*	*32,1*	*49,1*
R157 (13,5%; 2014/15/16)	*19,5*	*25,2*	*41,9*
R186 (10,5%; 2025/26/27)	*9,5*	*10,8*	*15,0*
R194 (10%; 2007/08/09)	*26,9*	*18,8*	*27,4*
R201 (8,75%; 2014)	*12,7*	*7,7*	*7,7*
R203 (8,25%; 2017)	*13,6*	*16,1*	*12,9*
R204 (8%; 2018)	*10,5*	*17,8*	*18,5*
R206 (7,5%; 2014)	–	*8,5*	*22,2*
R207 (7,25%; 2020)	–	*6,4*	*17,3*
R208 (6,75%; 2021)	–	–	*18,3*
R209 (6,25%; 2036)	–	–	*25,0*
Inflation-linked			
R189 (6,25%; 2013)	*0,6*	*0,6*	*1,3*
R197 (5,5%; 2023)	*0,7*	*0,8*	*1,0*
R198 (3,8%; 2008)	*3,8*	*8,1*	*3,1*
R202 (3,45%; 2033)	*3,4*	*1,8*	*2,6*

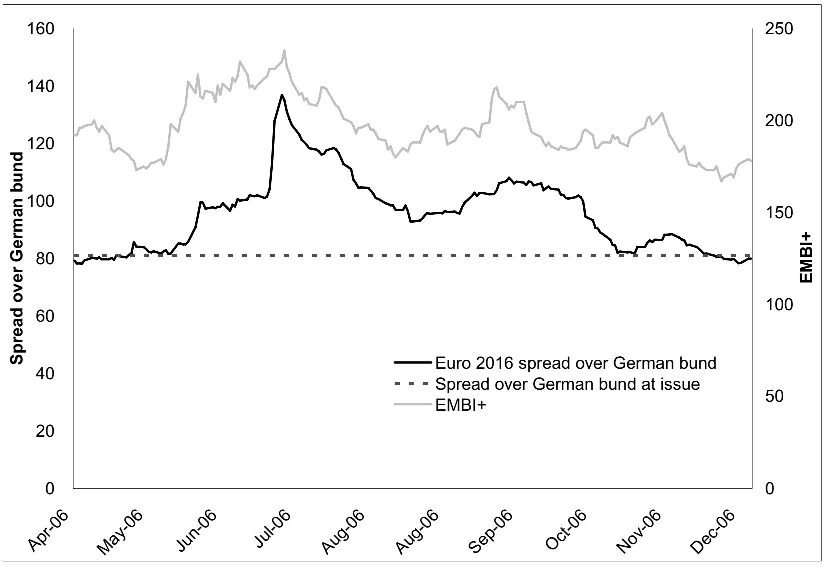
1. Turnover ratio represents the market turnover divided by the nominal outstanding issue of a bond.

Issuance in international capital markets

In March 2006, a 10-year, €750 million bond (4,5%; 2016) was successfully issued in international capital markets amid volatile global conditions. The euro bond was priced competitively with an interest coupon of 4,5 per cent, the lowest ever achieved by South Africa in the euro market.

The euro bond had an interest coupon of 4,5 per cent – the lowest so far in this market

Figure 5.3 €750 million 2016 bond spread, 2006



When comparing South Africa's foreign-currency-denominated bond spreads with those of other emerging markets, it is evident that South Africa experienced modest volatility during 2006. The 2016 global

South Africa experienced modest volatility in 2006

bond has reverted to the spread of 78 basis points over the underlying German treasury bond, below the issuance spread of 81 basis points, indicating continued international investor confidence in the country.

Long-term sovereign debt receives another rating upgrade

In December 2006, Rating and Investment Information (R&I) of Japan upgraded South Africa's long-term sovereign debt credit rating from BBB+ to A-. Moody's Investors Service, Standard & Poor's and Fitch Ratings reaffirmed the country's BBB+ credit rating for 2006. Companies benefited from the improved sovereign credit ratings, as reflected in improved corporate ratings.

Table 5.2 Performance of foreign bonds[1], 2006

Bond	Coupon	Issue date	Maturity date	Issue spread	Average spread for 2006
Million	%			bps[2]	bps[2]
United States dollar					
1 500	*9,125*	*May 1999*	*May 2009*	*362/275[3]*	*76*
1 000	*7,375*	*April 2002*	*April 2012*	*240*	*95*
1 000	*6,500*	*June 2004*	*June 2014*	*195*	*96*
500	*8,500*	*June 1997*	*June 2017*	*183*	*107*
Euro					
500	*7,000*	*April 2001*	*April 2008*	*272*	*34*
1 250	*5,250*	*May 2003*	*May 2013*	*142*	*92*
750	*4,500*	*April 2006*	*April 2016*	*81*	*96*

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 (1/100th) 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.*

Demand for eurorand bonds remains strong

Activity in the eurorand bond market remained strong during 2006 as relatively high yields attracted investors. Gross issuance amounted to R10,9 billion, while R5,3 billion matured, resulting in net issuance of R5,6 billion. The maturity profile of issuances during 2006 varied between two and 10 years. Although issuances are still dominated by the multilateral development finance institutions, various new issuers have entered the eurorand bond market over the past couple of years. Increased demand for eurorand bonds is a strong signal of confidence in the South African economy and contributes positively to raising capital in rands.

Lower debt: a foundation for a prosperous future

Studies of countries that have prospered economically indicate that reducing government debt cost is an essential ingredient for growth. South Africa has undertaken this path since 1994. To ensure that future generations are not crippled by heavy debt loads, prudent debt management with a view to reducing debt, subject to acceptable risk levels, is a government priority.

Government debt fluctuates depending on whether the state runs a budget deficit or surplus. Stability of the economy, extraordinary receipts or payments, the absolute level of interest rates and exchange rates also play a role. Budget balance trends, percentages of debt stock and interest costs in relation to the economy are important indicators of debt sustainability. These indicators play a significant role in rating agencies' assessment of sovereign risk.

More than a decade of prudent macroeconomic policy, supported by an appropriate debt management strategy, has seen budget deficits declining from 5,1 per cent of GDP in 1994/95 to present budget surpluses. This has led to lower borrowing requirements. Government's net borrowing requirement declined from 5,1 per cent of GDP in 1994/95 to 0,3 per cent in 2009/10.

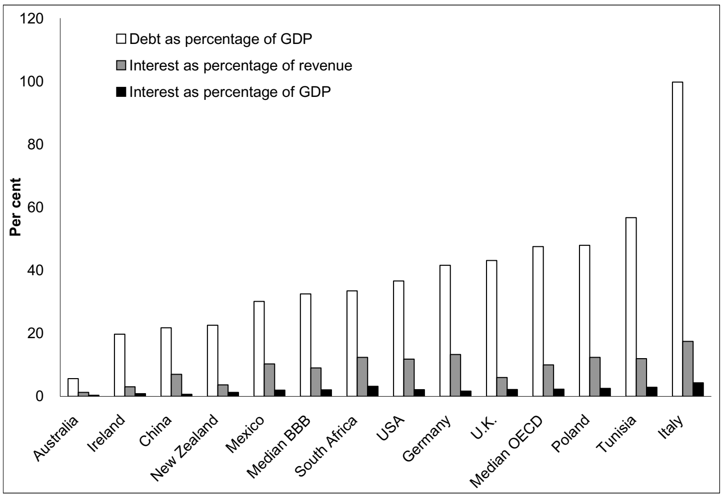
A lower borrowing requirement means that less new debt is issued. The percentage year-on-year increase in net debt has declined from 26 per cent in 1994/95 to only 1,1 per cent in 2006/07. Over the medium term this will average 1,2 per cent. Net debt as a percentage of GDP came down from 48,1 per cent in 1996/97 to 27,1 per cent in 2006/07, and is expected to fall to 20,7 per cent in 2009/10.

In 2007 net debt and revenue are roughly on par. Over the medium term debt will be on average R112 billion lower than revenue. Foreign debt as a percentage of total debt continues to decrease, from a high of 19 per cent in 2001/02 to a projected 14,3 per cent on 31 March 2007, and is expected to average 14,8 per cent over the MTEF. This is well below the risk benchmark of 20-25 per cent foreign debt.

Lower borrowing requirements and the slower increases in the stock of debt have had a positive impact on state debt cost, which as a percentage of GDP and revenue continues to fall. State debt cost as a percentage of GDP averaged 4,6 per cent between 1994/95 to 2005/06, declining steadily to 3 per cent in 2006/07, and is projected to reach a low of 2,1 per cent by 2009/10. State debt cost as a percentage of total revenue averaged 19,7 per cent between 1994/95 to 2005/06, declining to 11 per cent in 2006/07. Measured as a percentage of expenditure, over the past two years, this decline in debt service cost has released significant additional resources for economic development and poverty relief, roughly equivalent to R67 billion.

South Africa's debt sustainability ratios compare favourably with its peers with similar sovereign ratings, as well as some members of the Organisation for Economic Cooperation and Development, as shown in the figure below.

South Africa's debt sustainability ratios relative to selected countries



**Source: Standard & Poor's as at 31 December 2006*

Borrowing requirement

Government borrows to meet its net borrowing requirement – which is the sum of the main budget balance, extraordinary receipts and extraordinary payments – and to refinance maturing debt.

Negative net borrowing requirement in 2006/07 and 2007/08

Table 5.3 sets out the net borrowing requirement for 2005/06, a revised estimate for 2006/07 and estimates for the period ahead. In 2006/07 and over the medium term, government's total net borrowing requirement is negative, meaning that R6,6 billion of debt is bought back.

Table 5.3 Net borrowing requirement, 2005/06 – 2009/10

	2005/06	2006/07		2007/08	2008/09	2009/10
R million	Outcome	Budget	Revised	Medium-term estimates		
Budget balance[1]	5 012	26 363	-5 221	-10 728	3 032	8 787
Extraordinary receipts	-6 905	-1 700	-3 342	-1 250	-1 250	-1 250
Premiums on loan transactions[2]	*-2 408*	*-1 500*	*-827*	*-1 000*	*-1 000*	*-1 000*
Special dividends	*-1 697*	–	*-1 496*	–	–	–
Agricultural debt account surrender	*-150*	*-200*	*-200*	*-250*	*-250*	*-250*
Foreign Exchange amnesty proceeds	*-2 650*	–	*-350*	–	–	–
Lebowa Minerals Trust abolition	–	–	*-467*	–	–	–
Other	–	–	*-2*	–	–	–
Extraordinary payments	4 554	–	4 207	400	–	–
Premiums on loan transactions[2]	–	–	*422*	–	–	–
Defrayal of GFECRA losses[3]	*4 539*	–	–	–	–	–
Saambou Bank liability	–	–	*3 778*	*400*	–	–
Losses on conversion of foreign loans	*15*	–	*8*	–	–	–
Total	**2 661**	**24 663**	**-4 356**	**-11 578**	**1 782**	**7 537**

1. A negative number reflects a surplus and a positive number a deficit.
2. Premiums received or incurred on loan issues, bond switch and buy-back transactions and conversions of foreign loans.
3. Payments made to the Reserve Bank to defray realised losses on the Gold and Foreign Exchange Contingency Reserve Account.

Extraordinary receipts

Special dividends from Telkom and the Airports Company of South Africa

An amount of R1,7 billion was provided for extraordinary receipts in 2006/07, composed of premiums of R1,5 billion on bonds issued to finance the borrowing requirement and the transfer of R200 million to the National Revenue Fund from the agricultural debt account held at the Corporation for Public Deposits. These receipts are expected to increase to R3,3 billion due to special dividends (R828 million from Telkom and R668 million from the Airports Company of South Africa), foreign exchange amnesty proceeds (R350 million) and the winding up of the Lebowa Minerals Trust (R467 million). These amounts will be partly offset by R673 million in lower premiums on new loan issues due to an increase in the absolute level of interest rates.

Over the medium term, provision is made for premiums on bond issues of R1 billion a year. Over the same period, transfers from the agricultural debt account will amount to R750 million.

Extraordinary payments

Provision was made in 2005/06 for an amount of R4,3 billion to partially settle a liability relating to Saambou Bank. Due to protracted negotiations between the parties involved, an amount of R3,8 billion was only paid in 2006/07, with the balance of approximately R400 million to be settled in 2007/08. No further extraordinary payments are expected over the next three years.

Saambou Bank liability is nearly settled

In 2006/07 premiums on the buy-back of foreign and domestic loans amount to R422 million.

Financing of the borrowing requirement

Table 5.4 provides information on the funding of government's net borrowing requirement for 2005/06, revised estimates for 2006/07, and projections for 2007/08 to 2009/10.

Table 5.4 Financing of net borrowing requirement[1], 2005/06 – 2009/10

	2005/06	2006/07		2007/08	2008/09	2009/10
R million	**Outcome**	**Budget**	**Revised**	**Medium-term estimates**		
Domestic short-term loans (net)	5 716	5 800	5 800	5 750	5 750	5 750
Treasury bills	*6 000*	*6 000*	*6 000*	*6 000*	*6 000*	*6 000*
Corporation for Public Deposits	*-284*	*-200*	*-200*	*-250*	*-250*	*-250*
Domestic long-term loans (net)	23 086	8 694	1 407	-9 019	1 412	10 123
Market loans	*44 932*	*44 500*	*37 500*	*24 000*	*26 000*	*28 000*
Extraordinary issues	*4 539*	–	–	–	–	–
Redemptions	*-26 385*	*-35 806*	*-36 093*	*-33 019*	*-24 588*	*-17 877*
Foreign loans (net)	518	2 415	694	-2 587	-5 082	-6 822
Market loans	–	*6 227*	*5 509*	–	–	*8 590*
Arms procurement loan agreements	*2 904*	*3 569*	*4 200*	*3 533*	*2 640*	*430*
World Bank loans [2]	*43*	*13*	–	–	–	–
Redemptions (including revaluation of loans)	*-2 429*	*-7 394*	*-9 015*	*-6 120*	*-7 722*	*-15 842*
Change in cash and other balances[3]	-26 660	7 754	-12 257	-5 723	-298	-1 514
Opening balance	31 527	54 411	61 871	75 628	82 851	84 648
Cash balance	*30 870*	*52 911*	*58 187*	*74 128*	*81 351*	*83 148*
Surrenders/late requests	*1 976*	*1 500*	*3 684*	*1 500*	*1 500*	*1 500*
Cash flow adjustment [4]	*-1 319*	–	–	–	–	–
Closing balance	-58 187	-46 657	-74 128	-81 351	-83 148	-86 162
Sterilisation deposits [5]	*-35 944*	*-37 600*	*-45 594*	*-48 594*	*-51 094*	*-53 594*
Operational cash	*-22 243*	*-9 057*	*-28 534*	*-32 757*	*-32 054*	*-32 568*
Total	**2 661**	**24 663**	**-4 356**	**-11 578**	**1 782**	**7 537**

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

Funding strategy takes into account 70/30 fixed-floating risk benchmark

The funding strategy takes into account risk benchmarks of 70/30 fixed-rate versus variable/floating rate domestic debt, and a range of 20-25 per cent maximum exposure to foreign debt as a percentage of total debt.

Scheduled loan redemptions for 2005/06 and 2006/07 and medium-term estimates are set out in Table 5.5. Loan redemptions in 2006/07 amount to R45,1 billion. This is R1,9 billion more than anticipated, mainly due to the repurchase of domestic bonds from the Reserve Bank's monetary management bond portfolio and the prepayment of a foreign loan of US$263 million (R1,8 billion). On average, foreign loans were redeemed at more favourable exchange rates than predicted resulting in a lower rand value paid.

Projected loan redemptions of R39,1 billion in 2007/08

In 2007/08, total loan redemptions of R39,1 billion are anticipated, comprising domestic debt of R33 billion and foreign loans of R6,1 billion. Loan redemptions are projected to be R32,3 billion and R33,7 billion respectively over the two outer years of the MTEF.

Government's borrowing requirement is financed through domestic short- and long-term loans, foreign loans and changes in cash balances.

Table 5.5 Loan redemptions, 2005/06 – 2009/10

	2005/06	2006/07		2007/08	2008/09	2009/10
R million	**Outcome**	**Budget**	**Revised**	**Medium-term estimates**		
Domestic loans	26 385	35 806	36 093	33 019	24 588	17 877
Foreign loans	2 429	7 394	9 015	6 120	7 722	15 842
Principal	*1 964*	*6 004*	*7 248*	*5 647*	*5 345*	*12 933*
Revaluation	*465*	*1 390*	*1 767*	*473*	*2 377*	*2 909*
Total	**28 814**	**43 200**	**45 108**	**39 139**	**32 310**	**33 719**
Excludes: Source bonds in domestic switch auctions	*4 539*	–	–	–	–	*16 000*

Domestic short-term loans

Treasury bills with maturities of 3, 6 and 9 months have been issued

Short-term borrowing in the domestic market consists of Treasury bill issuance and borrowing from the Corporation for Public Deposits. Treasury bills are short-term marketable instruments. To date, Treasury bills with maturities of 3 months, 6 months and 9 months have been issued, but bills of shorter periods can also be issued for bridging finance purposes.

Treasury bill increase of R6 billion annually over MTEF

In 2006/07, Treasury bills increase by a net R6 billion. The same annual increase is provided for over the next three years. Treasury bills were issued at an average yield of 7,7 per cent in 2006/07.

Borrowing from the Corporation for Public Deposits will decrease by R200 million in 2006/07, and by R750 million over the period 2007/08 to 2009/10, due to transfers from the agriculture debt account to the Exchequer account.

Money borrowed from the Corporation for Public Deposits for bridging finance purposes and to sterilise the money market impact of flows on government's accounts with the Reserve Bank varies during the course of the year.

Domestic long-term loans

A net new supply of R1,4 billion in government bonds

Domestic long-term loans consist of fixed-income bonds, inflation-linked bonds, floating rate notes and RSA retail bonds. The 2006/07 domestic long-term loan issuance amounts to R37,5 billion, which represents a R1,4 billion net new supply of government bonds to the market.

Fixed-income bonds remain government's main source of financing

Table 5.6 provides a breakdown of the R32,5 billion in government bonds issued in 2006/07 up to 31 January 2007. Fixed-income bonds constitute 73,7 per cent of total issuance, while inflation-linked bonds and floating rate notes account for 19,5 per cent and 6,8 per cent, respectively. Fixed-income bonds were issued at a weighted average nominal yield of 8,0 per cent, while inflation-linked bonds were issued at a weighted average real yield of 2,6 per cent.

New fixed-income bonds R208 (6,75%; 2021) and R209 (6,25%; 2036) were well received by the market. As at 31 January 2007 issuance in the R209 bond reached R3,6 billion and R2 billion in the R208 bond.

Demand for inflation-linked bonds remained high in 2006/07, with 85,3 per cent of total inflation-linked bond issuance in the longer maturity R197 (5,5%; 2023) and R202 (3,45%; 2033) bonds. Issuance of the R205 (2012) floating rate note was R2,2 billion as at 31 January 2007.

Negative supply of R9 billion domestic bonds in 2007/08

As shown in Table 5.4, projected domestic long-term loan redemptions exceed new loan issues by R9 billion in 2007/08. Over the next two years, net domestic long-term loan issuance will average R5,8 billion. No new fixed-income bonds will be introduced in 2007/08. Issuance will be in the existing fixed-income benchmark bonds – the R153, R157, R186, R201, R203, R204, R206, R207, R208 and R209, concentrating on the medium to long-term maturity bonds. This issuance strategy will be in line with government's objective of enhancing price discovery and efficiency in the bond market. A premium is achieved by building volumes in the existing benchmark bonds.

The R198 inflation-linked bond redeeming in 2007/08 will be replaced by a new inflation-linked bond in the 2027/28 maturity area. This will maintain a developed real yield curve and enhance the diversity of maturities in government's inflation-linked portfolio.

New inflation-linked retail bonds and new sales channel

Total investments in retail bonds for 2006/07 as of 31 January 2007 amount to R434 million of which R226 million is reinvestment of maturing bonds and capitalised interest. New inflation-linked retail bonds in 3-year, 5-year and 10-year maturities will be introduced in 2007/08. A new sales channel will also be launched.

Table 5.6 Domestic long-term market loan issuance, 2006/07

As at 31 January 2007 R million	Cash value	Average yield %
Fixed-income	23 946	8,03
R186 (10,5%; 2025/26/27)	*2 322*	*7,92*
R201 (8,75%; 2014)	*1 261*	*8,39*
R203 (8,25%; 2017)	*1 850*	*7,94*
R204 (8%; 2018)	*4 838*	*8,33*
R206 (7,5%; 2014)	*3 819*	*7,79*
R207 (7,25%; 2020)	*3 869*	*7,90*
R208 (6,75%; 2021)	*1 977*	*8,21*
R209 (6,25%; 2036)	*3 576*	*7,89*
Retail	*434*	*8,26*
Inflation-linked	6 335	2,55
R189 (6,25%;2013)	*212*	*2,54*
R197 (5,5%; 2023)	*2 861*	*2,62*
R198 (3,8%;2008)	*721*	*2,35*
R202 (3,45%; 2033)	*2 541*	*2,54*
Floating rate	2 200	7,19
R205 (floating; 2012)	*2 200*	*7,19*
Total	**32 481**	

Foreign loans

Foreign loan issues as of 31 January 2007 are set out in Table 5.7. In 2006/07, provision was made for new international capital market loans equivalent to US$1 billion (R6,2 billion). The capital market loan proceeds were slightly lower due to a €750 million issue and a stronger domestic currency at the time of issuance.

Government does not plan to borrow in world capital markets over next two years

Government does not envisage borrowing in the international capital markets over the next two years as a result of the lower borrowing requirement. However, to maintain a presence in the international capital markets, an active foreign debt management strategy will be followed. Provision is made for a US$1 billion equivalent capital market loan in 2009/10.

By 2006/07, government will have made total drawdowns of R23,9 billion, or 75,7 per cent of the total drawdowns in terms of the international arms procurement loan agreements. Drawdowns on these loans over the next three years will decrease from R3,5 billion to R430 million in line with the completion of this programme.

Table 5.7 Foreign loan issues, 2006/07

As at 31 January 2007 R million	
Market loans	5 509
Concessionary: World Bank loan	–
Arms procurement loan agreements	3 609
AKA-Commerzbank (Submarines)	*611*
AKA-Commerzbank (Corvettes)	*25*
Societe Generale (Corvettes)	*14*
Barclays (Hawk / Gripen)	*2 959*
Total	**9 118**

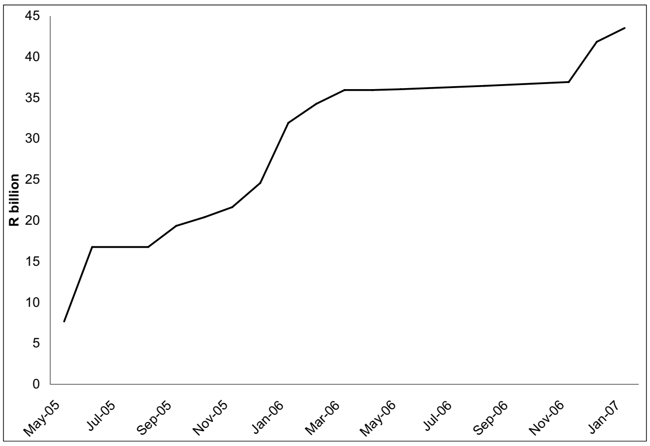
Increase in official reserves

Net official reserves have increased to US$23,3 billion in January 2007, from a negative US$23,2 billion in 1998. The higher level of reserves has improved South Africa's foreign liquidity position, reduced external vulnerability, and improved macroeconomic and financial stability, leading to an improvement in sovereign credit ratings and a lower cost of doing business.

To add to reserve levels over the past two years, the National Treasury helped "sterilise" excess cash by drawing R43,5 billion from its deposits with commercial banks and holding these balances in an interest-bearing sterilisation account with the Reserve Bank, as shown in the figure below. These sterilisation deposits enabled the Reserve Bank to increase reserve levels by US$6,7 billion.

The buyback of US$1,1 billion worth of foreign loans by the National Treasury and the Reserve Bank also helped to reduce external vulnerability.

Sterilisation deposits with Reserve Bank to increase official reserves, 2005-2007



Cash balances

In 2006/07, government's opening cash balances amounted to R58,2 billion against a budgeted amount of R52,9 billion. The higher opening balance is mainly due to a delayed Saambou Bank liability payment of R4,3 billion, and higher net surrenders and late requests by departments.

New sterilisation deposits of R8 billion

Sterilisation deposits with the Reserve Bank in 2006/07 increased by R9,7 billion, from R35,9 billion to R45,6 billion, as a result of capitalised interest of R1,7 billion and new sterilisation deposits of

R8 billion. From 2007/08 to 2009/10, sterilisation deposits are projected to increase to R53,6 billion due to capitalised interest.

Cash balances to increase in line with requirements

To provide for the ¥60 billion loan redemption in July 2007, operational cash balances of R28,5 billion are anticipated at the end of 2006/07. Over the medium term, operational cash balances should increase to an annual average of R32,5 billion, in line with government's projected cash flow requirements.

Government's cash balances

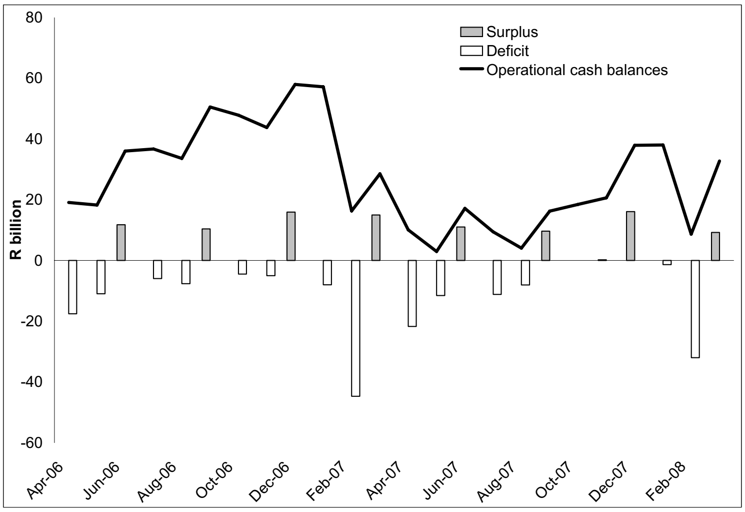
The National Treasury is responsible for maintaining adequate funds for government in the National Revenue Fund and investing surplus cash. Government's total cash includes deposits held by the Reserve Bank and the commercial banks.

The Reserve Bank uses the deposits that it holds to "sterilise" the excess cash created in the money market when purchasing official reserves. These sterilisation deposits are not available to finance government's borrowing requirement, as this would increase the money supply.

Operational cash available to finance government's borrowing requirement is held in the tax and loan accounts with the four commercial banks. The level of operational cash is determined by future cash requirements. Peaks arise from seasonally high expenditure in April to May and interest payments in August and February. The repayment of loans in February and March increases the cash requirements. Over February and March 2007, the cash requirement for loan redemptions, interest and SACU payments amount to R60,8 billion.

Monthly cash requirements and operational cash balances in 2006/07 and projections for 2007/08, depicted in the figure below, show that although operational cash amounted to R57,2 billion at the end of January 2007, balances will decrease to about R2,5 billion before corporate and other tax receipts in June and September 2007.

Monthly gross surplus/deficit before borrowing and operational cash balances, 2006/07 and 2007/08



Size and structure of government's debt portfolio

Total debt

Table 5.8 sets out the composition of government debt for the period 2003/04 to 2009/10. Net loan debt is calculated by taking into account the bank balances of the National Revenue Fund. In 2006/07, net loan debt increases by R5,0 billion to R475,5 billion. After decreasing to R470,2 billion by the end of 2007/08, net loan debt over the next two years will increase to R492,2 billion.

Table 5.8 Total government debt, 2003/04 – 2009/10

End of period	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
R billion		Outcome		Estimate	Medium-term estimates		
Domestic debt	390,5	432,4	461,8	470,9	469,0	477,3	494,3
Foreign debt[1]	64,7	69,4	66,8	78,7	82,6	84,0	84,1
Gross loan debt	**455,2**	**501,8**	**528,6**	**549,6**	**551,6**	**561,3**	**578,4**
Less: National Revenue Fund bank balances	-12,7	-30,9	-58,2	-74,1	-81,4	-83,1	-86,2
Net loan debt[2]	**442,5**	**470,9**	**470,4**	**475,5**	**470,2**	**478,2**	**492,2**
As percentage of GDP :							
Net loan debt	*34,3*	*32,9*	*29,8*	*27,1*	*24,3*	*22,3*	*20,7*
Foreign debt	*5,0*	*4,9*	*4,2*	*4,5*	*4,3*	*3,9*	*3,5*
As percentage of gross loan debt:							
Foreign debt	*14,2*	*13,8*	*12,6*	*14,3*	*15,0*	*15,0*	*14,5*

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).

Net loan debt declines to 27,1 per cent of GDP at end of 2006/07

As a percentage of GDP, net loan debt will decline to a projected 27,1 per cent at the end of 2006/07 from 29,8 per cent at the end of 2005/06. Total net loan debt as a percentage of GDP is expected to decline to 20,7 per cent in 2009/10, based on current projections of borrowing requirements, interest rates and exchange rates.

Foreign debt as a percentage of GDP continues to decline

Foreign debt as a percentage of GDP is estimated to decrease to 3,5 per cent over the same period. Foreign debt as a percentage of gross loan debt will increase to 14,5 per cent by 2009/10. As shown in Table 5.9, the increase in net debt over 2006/07 is mainly due to revaluation of government's foreign debt portfolio at projected exchange rates, resulting in an increase in debt of R11,1 billion. A more comprehensive presentation of government debt since 1982/83 is provided in Table 8 of Annexure B.

Table 5.9 Increase in government debt, 2006/07

R million	
Financing of net borrowing requirement (net of change in cash balances)	7 901
Discount on new loans	1 956
Revaluation of foreign debt portfolio	11 111
Increase in gross loan debt	**20 968**
Change in cash balances at bank[1]	-15 941
Increase in net loan debt	**5 027**

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

Maturity and composition of government debt

Average maturity of domestic bonds has declined to 7,9 years

The average maturity and duration of domestic marketable bonds is shown in Table 5.10. The average maturity has declined from 8,1 years in 2005/06 to 7,9 years in 2006/07. The weighted average term (duration) of interest and redemption cash flows has decreased from 5,3 years for 2005/06 to 5,1 years for 2006/07. This can be ascribed to the increase in the general level of interest rates.

Table 5.10 Maturity distribution of domestic marketable bonds, 2004/05 – 2006/07

Years	2004/05	2005/06	2006/07	
			Estimates	
Percentage of total	Portfolio[1]		Funding[2]	Portfolio[1]
0 – 3	22,2	21,9	2,3	28,0
3 – 7	32,7	25,2	7,5	20,9
7 – 10	16,9	24,1	14,9	23,8
10 – 19	18,8	18,8	50,5	19,1
Longer than 19	9,4	10,0	24,8	8,2
Years				
Average duration[3]	5,2	5,3	8,6	5,1
Average maturity	8,1	8,1	15,0	7,9

1. *The total bond portfolio as at the end of the period.*
2. *Bond issuances for the fiscal year.*
3. *The weighted average term (duration) of interest and redemption cash flows.*

Table 5.11 displays the composition of domestic debt, categorised by the various funding instruments.

Table 5.11 Composition of domestic debt by instrument, 2003/04 – 2006/07

End of period	2003/04	2004/05	2005/06	2006/07
R billion		Outcome		Estimate
Bonds	360,0	395,8	419,4	422,9
Fixed-income	*314,9*	*338,7*	*349,2*	*351,8*
Floating rate	*7,6*	*8,8*	*11,4*	*5,3*
Zero coupon	*2,3*	*2,3*	*2,2*	*2,2*
Inflation-linked	*35,2*	*44,7*	*54,8*	*62,1*
Retail	*–*	*1,3*	*1,8*	*1,5*
Treasury bills	29,9	36,1	41,9	47,7
Shorter than 91-days[1]	*1,3*	*1,6*	*1,4*	*1,2*
91-days	*23,4*	*29,3*	*28,0*	*30,4*
182-days	*5,2*	*5,2*	*7,8*	*9,0*
273-days	*–*	*–*	*4,7*	*7,1*
Other[2]	0,6	0,5	0,5	0,3
Total	**390,5**	**432,4**	**461,8**	**470,9**

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

Of total domestic debt at the end of 2006/07, 74,7 per cent is estimated to consist of fixed-income bonds. Inflation-linked bonds will constitute 13,2 per cent and Treasury bills 10,1 per cent.

Dollar- and euro-based debt is up, and yen-based debt is down

A currency breakdown of foreign debt obligations from 2003/04 is set out in Table 5.12. The table indicates a moderate increase in US dollar- and euro-denominated debt from 36,4 per cent and

44,6 per cent in 2003/04 to an estimated 37,3 per cent and 46,9 per cent in 2006/07, respectively. Yen-denominated debt declines from 15,3 per cent in 2003/04 to an estimated 8,9 per cent in 2006/07.

Table 5.12 Currency breakdown of foreign debt, 2003/04 – 2006/07

End of period Percentage of total	2003/04	2004/05	2005/06	2006/07 Estimate
Euro	44,6	42,7	42,5	46,9
United States dollar	36,4	43,1	43,8	37,3
Japanese yen	15,3	10,2	9,6	8,9
British pound	2,6	2,7	1,2	1,5
Swedish krone	0,6	0,7	2,0	4,4
Gold	0,5	0,6	0,9	1,0

Contingent liabilities

Contingent liabilities of R155,6 billion as of 31 March 2006 are summarised in Table 5.13.

Table 5.13 Composition of contingent liabilities, 2003/04 – 2005/06

End of period R billion	2003/04	2004/05	2005/06
Guarantees	79,6	74,1	67,9
Domestic	*59,6*	*55,4*	*49,8*
Foreign	*20,0*	*18,7*	*18,1*
Road Accident Fund[1]	18,5	20,1	21,4
Post retirement medical assistance[1]	37,0	37,0	37,0
Export Credit Insurance Corp. S.A. Ltd.	7,5	8,7	7,2
Government pension funds[1]	3,0	9,8	9,8
SASRIA reinsurance cover	1,0	1,0	1,0
Unemployment Insurance Fund[1]	2,5	2,3	2,3
Other[2]	7,5	8,1	9,0
Total	**156,6**	**161,1**	**155,6**

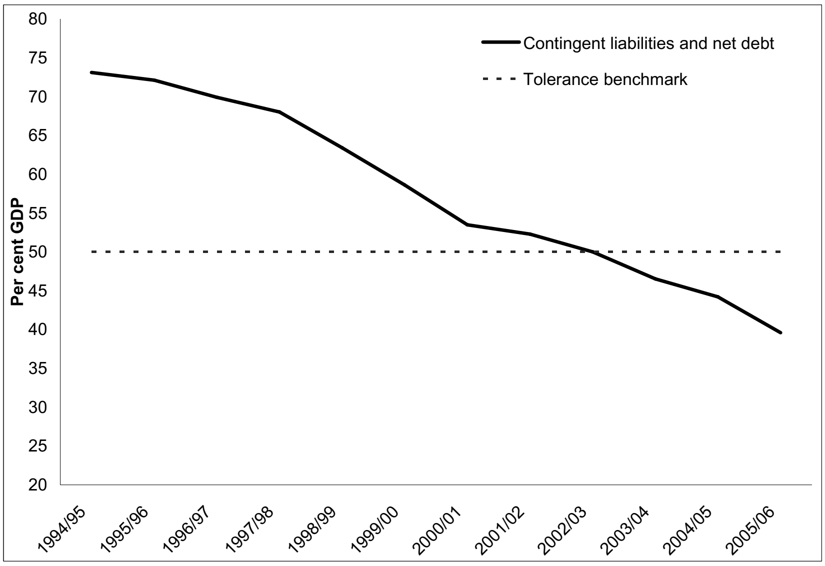
1. The Road Accident Fund, post retirement medical assistance to government employees, government pension funds and Unemployment Insurance Fund are subject to actuarial valuation periods varying from one year to four years.

2. Mainly represents departmental commitments relating to capped leave.

Contingent liabilities decline as a percentage of GDP

Contingent liabilities as a percentage of GDP declined from 26,1 per cent in 1994/95 to 9,8 per cent in 2005/06. According to the National Treasury's risk management guidelines, total contingent liabilities and debt should not exceed 50 per cent of GDP. Debt and contingent liabilities as a percentage of GDP declined from a high of 73 per cent in 1994/95 to 39,6 per cent in 2005/06.

Figure 5.4 Contingent liabilities, 1994/95 – 2005/06



Guarantees supported restructuring of Transnet and infrastructure projects

The guarantees were mainly utilised in the transport sector for the restructuring of Transnet, in the water sector for development of infrastructure (the Lesotho Highlands Water Project) and in the financial sector for the utilisation of bilateral funding channelled through the Development Bank of Southern Africa and the Industrial Development Corporation.

Guarantee exposure declines

Government's guarantee exposure in 2006/07 declined by R1,5 billion, mainly as a result of the partial redemption of a Saambou Bank guarantee, a new guarantee to the Land Bank and currency revaluation of guaranteed foreign loans. Guarantee fees of R31 million were received from state-owned entities in 2006/07. Details of government's guarantee commitments are set out in Table 9 of Annexure B.

State debt cost

The volume of debt, new borrowing requirements, interest rates and the value of currency influence the level of state debt cost. Table 5.14 summarises trends and projections of state debt cost between 2005/06 and 2009/10.

Table 5.14 State debt cost, 2005/06 – 2009/10

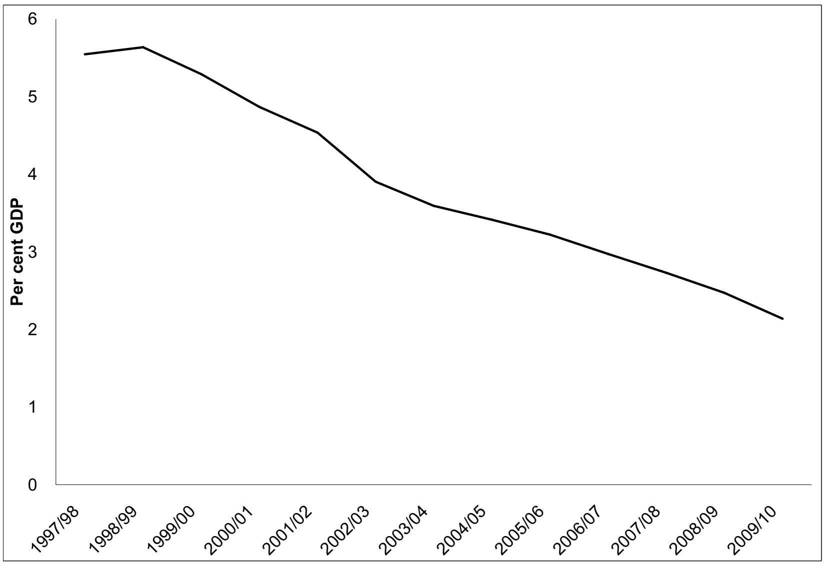
	2005/06	2006/07		2007/08	2008/09	2009/10
R million	**Outcome**	**Budget**	**Revised**	**Medium-term estimates**		
Domestic	46 533	47 366	47 631	48 052	47 758	45 890
Foreign	4 379	4 683	4 547	4 864	5 209	5 025
Total	**50 912**	**52 049**	**52 178**	**52 916**	**52 967**	**50 915**
State debt cost as percentage of :						
GDP	*3,2*	*3,0*	*3,0*	*2,7*	*2,5*	*2,1*
GDP-accrual [1]	*3,5*	*3,3*	*3,1*	*2,9*	*2,7*	*2,4*
Revenue	*12,4*	*11,7*	*11,0*	*9,7*	*9,0*	*7,9*

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

In 2006/07, state debt cost is estimated to be R129 million higher than the budgeted amount of R52 billion, due to higher interest rates and currency depreciation. State debt cost will average R52,9 billion over the next two years before declining in 2009/10 to 2005/06 levels.

State debt cost to average R52,9 billion over next two years, declining in 2009/10

Figure 5.5 State debt cost continues to decline, 1997/98 – 2009/10[1]



1. The values for 2006/07 – 2009/10 are forecasts.

State debt cost as a percentage of GDP is projected to decline to 2,1 per cent in 2009/10. Measured as a percentage of revenue and expenditure, debt service cost will decline to 7,9 per cent and 7,8 per cent by 2009/10, respectively.

Debt service costs continue to fall

An accrual-based accounting for the stock of state debt and cost will result in the amortisation of the discount over the term of the bond, leading to higher debt cost, higher deficit and a lower aggregate measure of government debt. The adjusted state debt cost ratios are displayed in Table 5.14. Net government debt on an accrual-adjusted basis is on average 0,8 per cent lower than the nominal aggregates over the medium term.

State-owned entities

The major state-owned entities are focusing on investment in infrastructure to support economic growth, job creation and poverty reduction. Government has also undertaken efforts to improve financial performance and corporate governance in state-owned entities.

The National Treasury is at an advanced stage in its review of the treasury operations of state-owned entities. Discussions with the relevant entities are underway. In addition, the National Treasury, in conjunction with the relevant departments, is finalising arrangements to review the mandates of 12 development finance institutions. The review will culminate in the development of a development finance policy.

Review of treasury operations of state-owned entities at an advanced stage

Integrated strategic financial model developed

An integrated strategic financial model for all state-owned entities listed under schedule 2 of the Public Finance Management Act (1999) is being developed to monitor their financial performance and efficiency against predetermined targets, and to assess risks and opportunities.

State-owned entities provide dividends to the national budget, contributing to government's ability to fund social services. Government has developed a dividend and capital structure policy document that will guide the public entities. The policy seeks to encourage the enhancement of transparency and accountability; recognition of opportunity cost associated with government's equity investments; appropriate returns on equity; efficient, commercially based investment decisions; appropriate incentives for boards and management; greater certainty regarding entities' capital structures; and a relatively stable stream of total dividends to government.

Management models for state entities under consideration

The National Treasury, Department of Public Enterprises, and Department of Public Service and Administration are researching appropriate shareholder management models for state-owned entities.