7

Financing government's borrowing requirement

In brief

- Government's net borrowing requirement is expected to be R173.1 billion in 2015/16, decreasing to R155.5 billion in 2017/18.
- South Africa's deep and liquid domestic capital markets, and its access to international borrowing, continue to provide resources for government's financing needs.
- During 2015, three new bonds will be issued. These instruments will broaden funding options, help to smooth the maturity profile of government debt and reduce short-term refinancing risk.
- Net debt, provisions and contingent liabilities are expected to amount to 58.1 per cent of GDP in 2015/16, decreasing to 57.3 per cent in 2017/18.

Overview

Over the past five years, government has expanded its borrowing programme in response to difficult economic circumstances. Revenue collection has continued to underperform due to weak economic growth, leading to increased debt accumulation to support the fiscal stance. As a percentage of GDP, net debt has grown from 21.8 per cent at the start of the financial crisis in 2008/09 to 40.8 per cent in 2014/15.

Fiscal adjustments aim to ensure that debt remains at sustainable levels

The 2014 *Medium Term Budget Policy Statement* initiated several adjustments to fiscal policy. These measures are intended, in part, to arrest the pace of debt growth. Unsustainable debt levels would threaten South Africa's investment-grade credit rating and jeopardise the country's ability to finance the budget deficit without a substantial increase in debt-service costs. Moreover, a failure to stabilise debt would compromise government's ability to respond to future economic shocks.

Net debt to stabilise at 43.7 per cent of GDP in 2017/18

Government's borrowing plans over the next three years reflect a prudent approach to accumulating and managing debt. The medium-term fiscal framework will result in net debt stabilising at 43.7 per cent of GDP in 2017/18.

The net borrowing requirement of R180.9 billion in 2014/15 is R1.1 billion higher than projected in the 2014 Budget, and is expected to decrease to R173.1 billion in 2015/16. Domestic capital markets will remain the main source of financing. To continue smoothing the maturity profile of government debt – ensuring that repayments of the principal amounts are spread out over time – three new bonds will be issued. Two of these instruments will be set at fixed rates and one will be linked to inflation. Government intends to gradually reduce the weight of inflation-linked bonds in its portfolio in line with strategic benchmarks underpinning its borrowing programme (see Table 7.8). These benchmarks ensure that the debt portfolio is maintained within manageable parameters.

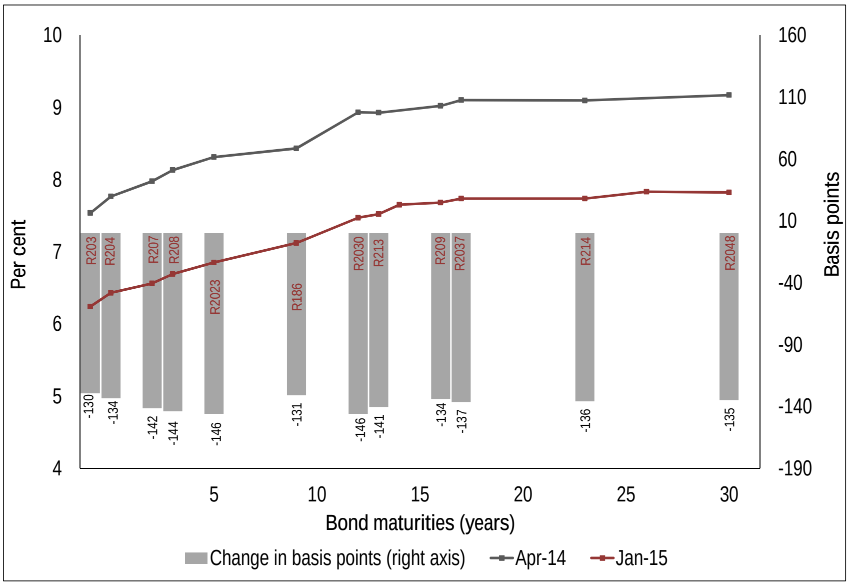
Borrowing in global capital markets in 2015/16 will finance part of government's foreign-currency commitments, with any remaining shortfall financed from surplus cash. Net debt, provisions and contingent liabilities will decline to 57.3 per cent of GDP in 2017/18. Details appear in Table 11 of the statistical tables at the back of the *Budget Review*.

South African debt markets

Credible fiscal and monetary policy support decline in bond yields

Since April 2014, government bond yields have decreased by an average of 138 basis points, despite expectations of higher yields globally on conclusion of the US quantitative easing programme. The decline in yields and lower borrowing rates in the rest of the economy can be attributed to credible management of fiscal and monetary policy, supported by lower oil prices and lower inflation expectations. Given the generally favourable movement in yields over the past year, local-currency government bond auctions were well supported by both domestic and international investors.

Figure 7.1 Fixed-rate bond yield curve movement



Source: Bloomberg

Short-term interest rates are largely anchored by the Reserve Bank's repurchase (repo) rate – the rate at which private banks borrow from the central bank. The Reserve Bank hiked the repo rate in July 2014 from 5.5 per cent to 5.75 per cent on concerns about higher inflation. Since then the Bank has kept the repo rate unchanged, anchoring short-term rates.

Holdings in domestic bonds by global investors increase to R448.9 billion

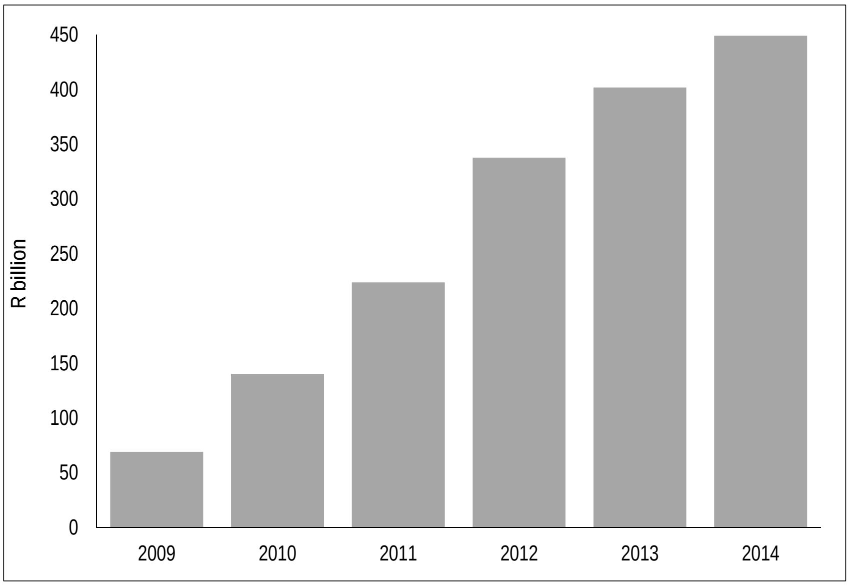
Growing participation by international investors in the local government bond market has helped to reduce domestic interest rates. Despite anxiety over emerging-market risks, global investors continue to see value in South Africa. Non-residents purchased a net R47 billion of local currency government bonds during 2014, increasing their total holdings to R448.9 billion. As a share of total government domestic bonds, non-residents' holdings declined marginally from 36.4 per cent in December 2013 to 36 per cent in December 2014, owing to growth in total debt.

Table 7.1 Ownership of domestic government bonds, 2009 – 2014

Percentage of total	2009	2010	2011	2012	2013	2014
Non-residents	**13.8**	**21.8**	**29.1**	**35.9**	**36.4**	**36.0**
Residents	**86.2**	**78.2**	**70.9**	**64.1**	**63.6**	**64.0**
Pension funds	39.9	36.5	33.0	29.8	29.1	31.7
Monetary institutions	18.3	17.7	16.3	17.0	14.6	14.7
Insurers	12.4	14.1	11.6	9.4	8.6	8.2
Other financial institutions	13.2	8.1	8.0	5.8	8.2	8.7
Other	2.4	1.8	2.0	2.1	3.1	0.7

Source: Share Transactions Totally Electronic (STRATE)

Figure 7.2 Non-resident domestic government bond holdings, 2009 – 2014



Source: Share Transactions Totally Electronic (STRATE)

New electronic trading platform for government bonds to promote transparency and liquidity

In partnership with the Johannesburg Stock Exchange, the Financial Services Board and other market participants, the National Treasury is preparing to introduce an electronic trading platform for government bonds. The platform is expected to improve transparency and liquidity, and increase activity in the local-currency government bond market.

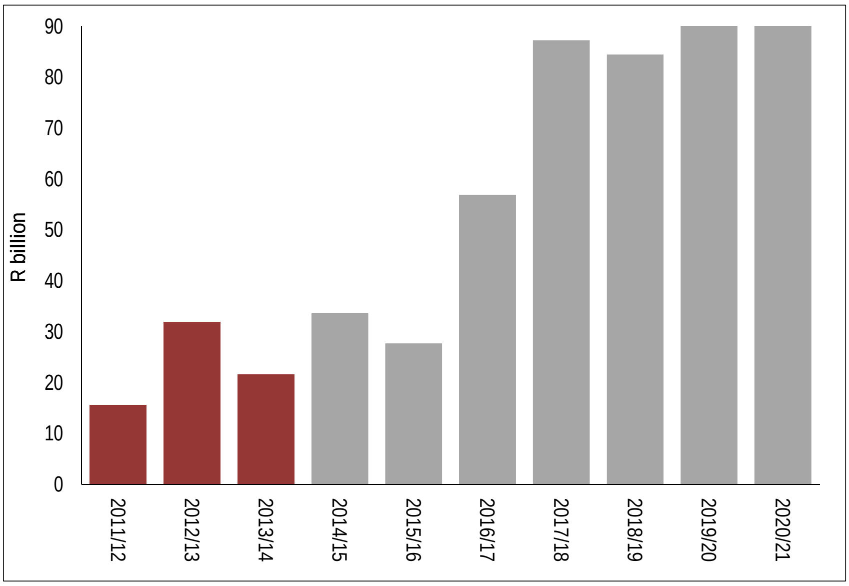
Medium-term borrowing strategy

Government's medium-term borrowing strategy describes how the state will finance the debt it will incur for the current year and over the next three years. The strategy takes into account debt levels, the main budget balance, funding instruments, cash-flow requirements, investor needs, development of the domestic market, and the risks and costs of alternative strategies.

Strategy aims to mitigate sharp increase in loan repayments from 2017/18

The strategy will focus on mitigating the risks presented by the sharp increase in loan repayments in 2017/18 and beyond. To meet these high loan repayments, cash will be generated from higher long-term borrowing in 2014/15. Over the medium term, the cash will be used to pay down short-term borrowing. In addition, government will continue to exchange short-dated bonds for longer-term bonds as market conditions permit.

Figure 7.3 Domestic government bond maturities, 2011/12 – 2020/21



Source: National Treasury

Financing the borrowing requirement

In 2014/15, net borrowing requirement will be R1.1 billion higher than projected in 2014 Budget

In 2014/15, government's net borrowing requirement will be R180.9 billion, R1.1 billion higher than projected in the 2014 Budget. The borrowing requirement will decrease to R144 billion in 2016/17 before increasing to R155.5 billion in 2017/18. In addition, government will borrow R191.9 billion over the medium term to finance debt due (loan redemptions).

Table 7.2 Financing of national government borrowing requirement,[1] 2013/14 – 2017/18

R million	2013/14 Outcome	2014/15 Budget	2014/15 Revised	2015/16	2016/17	2017/18
				Medium-term estimates		
Main budget balance[2]	**-160 499**	**-179 781**	**-180 853**	**-173 054**	**-143 957**	**-155 453**
Financing						
Domestic short-term loans (net)	**23 048**	**23 000**	**10 000**	**13 000**	**20 000**	**40 000**
Treasury bills	20 221	23 000	10 000	13 000	20 000	40 000
Corporation for Public Deposits	2 827	–	–	–	–	–
Domestic long-term loans (net)	**149 414**	**132 098**	**156 449**	**144 809**	**115 638**	**97 718**
Market loans (gross)	172 112	167 103	189 856	172 500	172 500	185 000
Loans issued for switches[3]	-1 135	–	247	–	–	–
Redemptions	-21 563	-35 005	-33 654	-27 691	-56 862	-87 282
Foreign loans (net)	**378**	**1 288**	**8 356**	**7 797**	**4 209**	**13 373**
Market loans (gross)	19 619	16 290	22 952	11 530	16 816	17 115
Redemptions (including revaluation of loans)	-19 241	-15 002	-14 596	-3 733	-12 607	-3 742
Change in cash and other balances[4]	**-12 341**	**23 395**	**6 048**	**7 448**	**4 110**	**4 362**
Cash balances	-16 292	18 895	1 847	3 662	-100	503
Other balances[5]	3 951	4 500	4 201	3 786	4 210	3 859
Total	**160 499**	**179 781**	**180 853**	**173 054**	**143 957**	**155 453**

1. A longer time series is presented in Table 1 of the statistical tables at the back of the Budget Review
2. A negative number reflects a deficit
3. Net of loans issued and redeemed in switch transactions
4. A negative change indicates an increase in cash balances
5. Net movement in national departments' bank balances due to differences between funds requested and actual cash flows
Source: National Treasury

Domestic short-term borrowing

Short-term borrowing consists of Treasury bill issuance and borrowing from the public sector through the Corporation for Public Deposits. The corporation is an institution into which provinces and state-owned companies are required to invest their surplus cash.

Table 7.3 Domestic short-term borrowing, 2014/15 – 2015/16

R million	2014/15 Opening balance	2014/15 Net change	2014/15 Closing balance	2015/16 Net change	2015/16 Closing balance	2014/15 Weekly auction estimates	2015/16 Weekly auction estimates
Corporation for Public Deposits	**21 812**	**–**	**21 812**	**–**	**21 812**		
Treasury bills	**192 206**	**10 000**	**202 206**	**13 000**	**215 206**	**7 215**	**7 370**
91-day	42 891	-9 696	33 195	–	33 195	2 685[1]	2 555
182-day	42 358	3 732	46 090	1 880	47 970	1 780	1 845
273-day	49 253	7 077	56 330	4 510	60 840	1 450	1 560
364-day	57 704	8 887	66 591	6 610	73 201	1 300	1 410
Total	**214 018**	**10 000**	**224 018**	**13 000**	**237 018**		

1. On 7 November 2014 auction levels were increased from R3.7 billion to R4.7 billion and reduced to R2.7 billion from 24 December 2014
Source: National Treasury

In 2014/15, the net increase in short-term loans will be R10 billion, increasing to R13 billion in 2015/16. In the two subsequent years, short-term loans increase by a net R60 billion to finance a sharp increase in loan redemptions. Borrowing from the Corporation for Public Deposit will be used to manage cash shortfalls during the year.

Domestic long-term borrowing

Domestic long-term loans consist of fixed-rate, inflation-linked and retail bonds. At R189.9 billion, domestic long-term loan issuance will be R23 billion more in 2014/15 than projected in the 2014 Budget due to higher-than-anticipated take-up of non-competitive fixed-rate bond auctions. Fixed-rate bonds accounted for 77.2 per cent of total bond issuance, with inflation-linked instruments making up the remainder.

Recent bond issuance has concentrated in longer maturities to minimise refinancing risk

Issuances were concentrated in the longer-maturity bonds in line with government's goal of minimising refinancing risk. The R2032 and R2044 fixed-rate bonds, issued for the first time in 2014, were well supported, accounting for 35.9 per cent of total fixed-rate bond issuance. These bonds were recently included in the All Bond Index – a composite index containing the top 20 fixed-rate bonds ranked according to liquidity (turnover) and average market capitalisation (outstanding amount). The index is tracked by fund managers, and the inclusion of these bonds improves their tradability.

Table 7.4 Domestic long-term borrowing, 2014/15

As of 31 January 2015 R million	Cash value	Average yield %	Outstanding value
Fixed-rate[1]	**124 656**	**8.74**	
R2023 (7.75%; 2023)	3 045	8.3	55 851
R186 (10.5%; 2025/26/27)	2 783	8.4	140 821
R2030 (8%; 2030)	22 289	8.6	39 111
R213 (7%; 2031)	4 993	8.5	83 138
R2032 (8.25%; 2032)	28 218	8.7	29 189
R209 (6.25%; 2036)	4 101	8.8	83 271
R2037 (8.5%; 2037)	15 864	8.9	36 045
R214 (6.5%; 2041)	6 358	8.9	78 399
R2044 (8.75; 2043/44/45)	16 508	8.9	16 619
R2048 (8.75%; 2047/48/49)	18 214	8.9	61 909
Retail	2 282	7.8	8 794
Inflation-linked[2]	**36 831**	**1.8**	
R212 (2.75%; 2022)	3 199	1.6	38 418
I2025 (2.0%; 2025)	10 211	1.6	28 200
I2038 (2.25%; 2038)	10 307	1.9	31 680
I2046 (2.5%; 2046)	6 271	1.9	14 843
I2050 (2.5%; 2049/50/51)	6 797	1.9	25 787
Retail	47	1.3	179
Total	**161 487**		

1. Includes non-competitive auction allocations of R30.8 billion
2. Outstanding value is revalued using the relevant reference consumer price index
Source: National Treasury

Domestic bonds are sold in weekly auctions. Both fixed-rate and inflation-linked bond auctions start with competitive bidding, where bidders propose a buying yield or rate. The highest bid offered is accepted for all successful bidders. In the case of fixed-rate bonds, competitive bidding is followed by a non-competitive bid auction, which gives successful bidders a 48-hour option to take up an additional 50 per cent of their competitive bid auction allocations at the yield at which the auction cleared.

To ensure that new bonds gain tradability within a short space of time, non-competitive auctions for bonds with an outstanding value of less than R10 billion were increased from 50 to 100 per cent of the primary auctioned amount; for bonds above R10 billion, the amount remained at 50 per cent. This strategy will be adopted for all new bond issuances. In 2014/15, it is expected that R37 billion, or about 20 per cent of total issuance in bonds, will be raised through non-competitive auctions.

About 20 per cent of bond issuance in 2014/15 expected to be raised in non-competitive auctions

In 2015/16, issuance of domestic long-term loans will decrease to R172.5 billion, before increasing to R185 billion in 2017/18 due to higher bond redemptions. While the weekly nominal fixed-rate competitive bond auction level will be maintained in 2015/16, the inflation-linked bond auctions will be decreased, depending on the level of take-up of non-competitive bond auctions. To broaden the funding options available, two new fixed-rate bonds and one inflation-linked bond will be introduced in 2015/16.

To broaden funding options, three new bonds will be introduced in 2015/16

Table 7.5 New domestic government bonds, 2015/16

Fixed-rate		Inflation-linked	
Bond code	**Maturity date**	**Bond code**	**Maturity date**
R2035	28 February 2035	I2033	28 February 2033
R2040	31 January 2040		

Source: National Treasury

Loan redemptions will increase sharply from an average of R26 billion over the past four years to R56.9 billion in 2016/17, averaging R88.5 billion per year in the four years thereafter.

The bond-switch programme will be used to partly mitigate refinancing risk – the risk that government will not be able to raise money to repay debt at any scheduled point, or will have to do so at a high cost. The programme eases pressure on targeted areas of the redemption profile by exchanging short-term for longer-term debt.

Domestic bond switch auctions to continue mitigating refinancing risk

During 2014/15, investments in RSA retail bonds amounted to R2.3 billion, of which R1 billion were reinvestments of maturing bonds and capitalised interest. A total of R9 billion is currently invested in these bonds. Government will consider introducing additional retail bond products to help improve the country's saving culture. The interest rates on RSA retail bonds are shown in Table 7.6.

Table 7.6 Interest rates on RSA retail bonds, February 2015

Percentage	Bond maturity		
Fixed-rate	**2-year**	**3-year**	**5-year**
	7.25	7.75	8.00
Inflation-linked	**3-year**	**5-year**	**10-year**
	1.25	1.75	2.00

Source: National Treasury

International borrowing

Despite volatile market conditions, emerging-market debt issuers raised US$480 billion in 2014, slightly higher than in 2013. The announcement of a shift in US monetary policy led to a higher pricing of risk in emerging markets, reflected in the widening of the JP Morgan EMBI+ sovereign spread index from 331 basis points at the start of the year to 404 basis points on 31 December 2014.

South Africa's prudent management of fiscal and monetary policy has anchored its credibility as an international borrower.

Foreign-currency bond issuances during 2014 were oversubscribed

Foreign-currency bond issuances during 2014 were significant milestones for South Africa's borrowing programme. The first dual-tranche international bond issue was well received in the dollar and euro capital markets. A dual-tranche bond issue combines various currencies and/or maturities in a single transaction, allowing an issuer to reach a broader range of investors. The 30-year US$1 billion note with a coupon rate of 5.375 per cent was priced at 220 basis points above the US Treasury benchmark bond. The 12-year €500 million note with a coupon of 3.75 per cent was priced at 225 basis points above the 12-year euro mid-swap rate. Both tranches were more than three times oversubscribed.

US$500 million raised through debut Sukuk

As announced in the 2014 Budget, South Africa entered the Sukuk market and raised US$500 million. The transaction was four times oversubscribed, with orders of US$2.2 billion, marking continued progress in efforts to broaden South Africa's investor base.

Structure of South Africa's debut Sukuk

Sukuk, the plural of the term "Sukk", is the Arabic name for a financial certificate, or a bond, which represents or evidences a proportionate interest in an underlying tangible asset and revenue. Sukuk holders are entitled to a periodic profit generated by the investment in the underlying assets.

South Africa's debut Sukuk are based on the most commonly used structure known as Al-Ijara, which represents securities with a usufruct interest over well-defined existing assets tied to a lease contract.

The Department of Water and Sanitation transferred three dams and one water tunnel, the Sukuk assets, to a trust whose trustees were appointed by the Minister of Finance. The trust holds the rights of use in the Sukuk assets during the 5.75-year bond period for the benefit of the Sukuk holders.

The trust has no rights to dispose of the Sukuk assets or of the rights of use in these assets other than by transferring the rights back to the Department of Water and Sanitation at the end of the transaction. The trust has entered into a lease agreement over the assets with National Treasury as the issuer of the Sukuk. The National Treasury pays rent on the assets for the tenor of the Sukuk and the rent is then distributed by the trust in the form of periodic payments to the Sukuk holders. At maturity, the capital is repaid, the underlying assets are transferred back to the Department of Water and Sanitation and the lease agreement ends.

US$4 billion will be borrowed from global markets over medium-term

Over the medium-term, government intends to borrow about US$4 billion in global markets to maintain benchmarks in major currencies and to meet part of its foreign-currency commitments of US$5.7 billion. The balance of these commitments will be met from drawdowns on cash balances and from foreign-currency purchases in the domestic market.

Cash balances

Government's total cash holdings, which consist of deposits in rands and US dollars held with commercial banks and the Reserve Bank respectively, will total R182 billion by the end of 2014/15, decreasing to R178.4 billion in 2015/16. Of government's total cash balances in 2014/15, R137 billion are deposits made with the Reserve Bank to increase the level of official foreign-exchange reserves and are only available for use by government as bridging finance.

Table 7.7 Change in cash balances, 2013/14 – 2017/18

	2013/14	2014/15		2015/16	2016/17	2017/18
R million	Outcome	Budget	Revised	Medium-term estimates		
Rand currency						
Opening balance	**103 774**	**123 157**	**120 807**	**112 157**	**112 157**	**110 157**
Closing balance	**120 807**	**107 157**	**112 157**	**112 157**	**110 157**	**107 157**
of which:						
Tax and loan accounts	*53 650*	*40 000*	*45 000*	*45 000*	*43 000*	*40 000*
Change in rand cash balance[1] (opening less closing balance)	**-17 033**	**16 000**	**8 650**	**–**	**2 000**	**3 000**
Foreign currency[2]						
Opening balance	**63 828**	**63 254**	**63 087**	**69 890**	**66 228**	**68 328**
Closing balance	**63 087**	**60 359**	**69 890**	**66 228**	**68 328**	**70 825**
US$ equivalent	*7 990*	*7 522*	*8 271*	*7 779*	*7 524*	*7 524*
Change in foreign currency cash balance[1] (opening less closing balance)	**741**	**2 895**	**-6 803**	**3 662**	**-2 100**	**-2 497**
Total change in cash balances[1]	**-16 292**	**18 895**	**1 847**	**3 662**	**-100**	**503**
Total closing cash balance	**183 894**	**167 516**	**182 047**	**178 385**	**178 485**	**177 982**

1. A negative value indicates an increase in cash balances and a positive value indicates that cash is used to finance part of the borrowing requirement
2. Rand values at which foreign currency was purchased or borrowed
Source: National Treasury

Due to rand depreciation, unrealised valuation gains related to foreign exchange are projected to increase

The losses and profits on the foreign-exchange activities of the Reserve Bank are accounted for on the Gold and Foreign Exchange Contingency Reserve Account. The balance on this government account is split into transactions with a cash-flow and non-cash-flow valuation impact. Due to the depreciation of the rand, unrealised valuation gains are expected to increase to R195.9 billion by end March 2015, R18.4 billion higher than a year earlier, with R121 million in realised losses to be settled by government.

Risk considerations

The borrowing strategy takes into account benchmarks designed to manage refinancing, inflation and currency risks. The benchmarks – which establish either a limit or a target range for a given category of debt – appear in Table 7.8, along with the actual position at the end of January 2015.

Table 7.8 Performance against strategic portfolio risk benchmarks

	Range or limits	
Benchmark description	**Benchmark**	**January 2015**
Share of short-term debt maturing in 12 months (Treasury bills)	15%	13.85%
Share of long-term debt maturing in 5 years	25%	24.22%
Share of inflation-linked bonds as a percentage of total domestic debt	20-25%	22.18%
Share of foreign debt as a percentage of total government debt	15%	9.15%
Average term-to-maturity (fixed-rate bonds + Treasury bills in years)	10-14	10.72
Average term-to-maturity (inflation-linked bonds in years)	14-17	14.91

Source: National Treasury

The main risks to government's borrowing programme are South Africa's credit ratings, global volatility in capital flows and a higher borrowing requirement:

- Standard & Poor's (BBB-, stable outlook) rates South Africa at one notch above investment grade, while Fitch (BBB, negative outlook) and Moody's (Baa2, stable outlook) are each one notch higher. Any deterioration in economic growth, the budget balance, or government's debt metrics could trigger rating downgrades, which would make government borrowing more expensive.
- Capital flows to emerging markets are expected to decline in 2015 due to the prospects of higher US interest rates. A sudden and sharp reversal of capital inflows could lead to a depreciation of the exchange rate and the repricing of government debt.
- A higher-than-anticipated wage bill, a deterioration in economic growth or funding difficulties at state-owned companies could increase the borrowing requirement, raising yields and borrowing costs.

Debt management will continue to support investment and improve the debt trajectory

Government's prudent fiscal policy and debt-management strategies, in combination with deep and liquid domestic capital markets, will continue to support investment, ensure that government can finance its borrowing requirement and improve the debt trajectory.