

## AFRICA RISK CONSULTING

### South Africa Monthly Briefing November 2017

#### South Africa Summary 23 November 2017

*Finance minister Malusi Gigaba delivers his first Medium-Term Budget Policy Statement (MTBPS), revising down forecast growth to 0.7% for 2017 and projecting a \$3.6 billion revenue shortfall. Ratings agencies including Moody's and Standard & Poor's are considering a downgrade of domestic debt following the MTBPS, which did not contain plans to revive growth. State-owned power utility Eskom faces serious liquidity issues in 2018 due to high costs, low tariffs and ongoing politically linked mismanagement. The treasury may need to bail out the power utility and South Africa faces further load shedding power cuts in 2018.*

#### Gigaba Medium-Term Budget Policy Statement fails to impress ...

Finance minister **Malusi Gigaba** delivered his first Medium-Term Budget Policy Statement (MTBPS) to parliament on 25 October.<sup>1</sup> The MTBPS presented a bleak overview of **South Africa's** current economic situation but observers accused Gigaba of putting off tough decisions and failing to suggest any viable alternative to the status quo.<sup>2</sup> In the MTBPS Gigaba addressed some of South Africa's major economic problems head on.<sup>3</sup> The treasury has revised economic gross domestic product (GDP) growth projection downwards to 0.7% from 1.3% in 2017, and to 1.1% in 2018 and 1.5% in 2019.<sup>4</sup> The budget deficit projection for 2017 also increased to 4.3% of GDP in 2017/18, up from 3.1% projected in the February budget.<sup>5</sup> The government faces a revenue shortfall due to low growth and tax receipts of R50.8 billion (\$3.6 billion), the largest shortfall since the economic crash of 2009.<sup>6</sup> It projects a growing shortfall of R69.3 billion (\$4.92 billion) for 2018/19 and R89.4 billion (\$6.93 billion) for 2019/20.<sup>7</sup>

The public sector wage bill has increased from 33% of expenditure in 2009 to 35% of expenditure in 2016/17.<sup>8</sup> This means that gross national debt will increase to 61% of GDP by 2022 with debt-service costs rising to 15% of budgeted revenue by 2029/21.<sup>9</sup> Gigaba said that the government needed to either cut costs or increase taxation by 0.8% of GDP to stabilise gross debt to a target of 60% of GDP across the next decade.<sup>10</sup> Gross debt will increase to 61% by 2020.<sup>11</sup> Gigaba announced an average spending increase of 7.3% across the next three years from R1.6 trillion (\$113 billion) in 2017/18 to R1.9 trillion (\$134 billion) by 2020/21.<sup>12</sup> The government exceeded its spending limit for 2016/17 by R3.9 billion (\$276m).<sup>13</sup> The markets have reacted negatively to the assessment of the economy with the rand falling 1.8% to R14.2/\$ during the speech, its weakest level in 2017, and it fell 5% against the

<sup>1</sup> Daily Maverick, 25 Oct 2017.

<sup>2</sup> Business Day, 25 Oct 2017.

<sup>3</sup> Source, South Africa analyst, United Kingdom

<sup>4</sup> MoneyWeb, 25 Oct 2017.

<sup>5</sup> MoneyWeb, 25 Oct 2017.

<sup>6</sup> MoneyWeb, 25 Oct 2017.

<sup>7</sup> MoneyWeb, 25 Oct 2017.

<sup>8</sup> Business Day, 25 Oct 2017.

<sup>9</sup> MoneyWeb, 25 Oct 2017.

<sup>10</sup> MoneyWeb, 25 Oct 2017.

<sup>11</sup> MoneyWeb, 25 Oct 2017.

<sup>12</sup> MoneyWeb, 25 Oct 2017.

<sup>13</sup> Business Day, 25 Oct 2017.

dollar overnight to a low of R14.35/\$.<sup>14</sup> The rand had remained at R13.1/\$ across 2017 but is at R13.87\$ at time of writing.<sup>15</sup>

Gigaba addressed the issue of state-owned enterprises (SOEs) draining billions of dollars from the fiscus, confirming that **South African Airways (SAA)** will get its full \$700m bail-out by the end of March.<sup>16</sup> Gigaba acknowledged that the **South African Post Office**, state defence developer **Denel**, **South African National Roads Agency Ltd (Sanral)**, **Transnet**, and the **Passenger Rail Authority of South Africa (Prasa)** are all receiving financial assistance from the government.<sup>17</sup> State-owned power utility **Eskom** is also facing multiple governance and financial issues, which Gigaba described as “a major risk to the entire economy”.<sup>18</sup> Gigaba talked tough on SOEs saying “no SOE should feel that they have a special relationship with government.”<sup>19</sup>

Gigaba told parliament “We are not in a position that is ideal. We need to chart a new path.”<sup>20</sup> However, the MTBPS was light on suggestions of what the new path might be and how the treasury could achieve it.<sup>21</sup> Gigaba said that the government would go ahead with the contentious sale of part of its 40% stake in part-privately owned telecommunications company **Telkom**.<sup>22</sup> Shares in Telkom fell 3% to a 19-month low on the news.<sup>23</sup> Gigaba also said that the government would consider further assets that it might sell, and would publish a list by 2018.<sup>24</sup> Gigaba said that fiscal consolidation was still on the agenda, however he gave neither details nor targets as to how this might be achieved.<sup>25</sup> One positive announcement was that the treasury would not fund the nuclear power programme that President **Jacob Zuma** (2009-present) champions.<sup>26</sup> Gigaba ran the MTBPS through the cabinet before publication, and minister in the presidency **Jeff Radebe** now has oversight of all fiscal consolidation through a process called the **Mandate Paper**.<sup>27</sup>

There is clear political gain for the ruling **African National Congress (ANC)** in avoiding tough decisions before its December *lekgotla* where its factions are fighting for control of the party.<sup>28</sup> Gigaba has pushed the majority of decisions back to the 2018/19 budget speech in February 2018, perhaps with this in mind.<sup>29</sup> However, the markets are unlikely to be forgiving of such an obviously political approach as the fall in value of the rand demonstrates. By pushing key decisions back Gigaba is gambling South Africa’s economic security for the ANC’s gain. The budget contains large-scale spending plans to bail out SOEs but no discernable measures to increase growth or reduce unemployment. Gigaba appears to believe that what ratings agencies and other observers want is a bleak assessment and conservative forecasts. However, South Africa risks junk status by failing to propose a way out of the current economic reality (see below).

### ... as leading ratings agencies consider junk status

International credit ratings agencies released statements on 30 October warning that they could downgrade South Africa’s debt below investment grade following the MTBPS on 25 October.<sup>30</sup>

<sup>14</sup> Xe.com

<sup>15</sup> Xe.com

<sup>16</sup> Daily Maverick, 25 Oct 2017.

<sup>17</sup> Daily Maverick, 25 Oct 2017.

<sup>18</sup> Daily Maverick, 25 Oct 2017.

<sup>19</sup> Daily Maverick, 25 Oct 2017.

<sup>20</sup> Business Day, 25 Oct 2017.

<sup>21</sup> Source, South Africa analyst, United Kingdom

<sup>22</sup> Business Day, 25 Oct 2017.

<sup>23</sup> MoneyWeb, 25 Oct 2017.

<sup>24</sup> Daily Maverick: 25 Oct 2017.

<sup>25</sup> MoneyWeb, 25 Oct 2017.

<sup>26</sup> Daily Maverick, 25 Oct 2017.

<sup>27</sup> Daily Maverick, 25 Oct 2017.

<sup>28</sup> Daily Maverick, 25 Oct 2017.

<sup>29</sup> Source, South Africa analyst, United Kingdom

<sup>30</sup> Business Day, 30 Oct 2017.

Gigaba's MTBPS planned for increased spending and borrowing, increased debt service costs and reduced revenues from 2017 to 2020 but did not outline detailed measures to change this.<sup>31</sup> Ratings agency **Moody's**, which currently rates South Africa's debt at one notch above investment grade, released a statement saying that if the projections in Gigaba's statement are true, South Africa's credit rating was on the brink of a junk rating.<sup>32</sup> Moody's South Africa analyst **Zuzana Brixiova** released the statement saying:

*"Unless the government presents a credible fiscal consolidation plan in the February 2018 budget, debt sustainability is at risk ...The lack of fiscal consolidation in the budget is also a setback to already feeble business confidence and growth."*<sup>33</sup>

Ratings agency **Fitch**, which already rates South Africa's domestic and foreign bonds as below investment grade, also released a critical statement on 26 October.<sup>34</sup> The statement accused Gigaba of failing to contain any impact the current economic situation had on deficits or debt, saying that the agency had *"lost confidence"*<sup>35</sup> in South Africa's budget ceilings and debt targets.<sup>36</sup> The statement noted that the MTBPS' economic forecast:

*"... suggests that the change in direction of policy making away from a focus on fiscal consolidation that we anticipated as a consequence of March's Cabinet reshuffle is under way and occurring faster than we had expected."*<sup>37</sup>

Analysts in South Africa believe that if Moody's and ratings agency **Standard & Poor's (S&P)** downgrade domestic denominated ratings to junk, significant capital outflows would follow on a far greater scale than a foreign denominated downgrade.<sup>38</sup> These would contribute to the further devaluation of South Africa's domestic bonds and would increase inflationary pressure on the rand.<sup>39</sup> Economists cited in the media believe this could trigger between R80 billion (\$5.6 billion) and R130 billion (\$9.2 billion) in bond sales from the key **World Government Bond Index**.<sup>40</sup> Sources within ratings agencies believe that they will wait until after the ANC *lekgotla* in December.<sup>41</sup>

The economic and political future of South Africa now rests on the result of the *lekgotla*. If the ANC elects a candidate that limits the influence of President Zuma – such as deputy president **Cyril Ramaphosa** – ratings agencies may be more likely to hold off on a negative rating adjustment.<sup>42</sup> However, if **Nkosazana Dlamini-Zuma** wins the election and Zuma retains his influence over the organs of state, the risk of a downgrade is high. Ratings agencies and the treasury have played a game of brinkmanship for the last three years on the issue of a downgrade. There is reason to believe that Moody's and S&P will wait until the February budget before making a decision. They are not punitive bodies, despite the claims of some of Zuma's supporters. However, their reputation is also on the line over South Africa. If the treasury forecasts a weak economy without giving a credible plan to alter the situation, then ratings agencies will find it difficult to justify not making a negative adjustment.

## **Eskom facing liquidity issues in 2018**

State-owned power utility Eskom faces serious liquidity issues in 2018 due to high costs, low tariffs and ongoing politically linked mismanagement, according to media reports on 13 November.<sup>43</sup> Eskom

<sup>31</sup> Source, South Africa analyst, United Kingdom

<sup>32</sup> Business Day, 30 Oct 2017.

<sup>33</sup> Moneyweb, 31 Oct 2017.

<sup>34</sup> Fin24, 26 Oct 2017.

<sup>35</sup> Fin24, 26 Oct 2017.

<sup>36</sup> Fin24, 26 Oct 2017.

<sup>37</sup> Fin24, 26 Oct 2017.

<sup>38</sup> Business Day, 30 Oct 2017.

<sup>39</sup> Business Day, 30 Oct 2017.

<sup>40</sup> Business Day, 30 Oct 2017.

<sup>41</sup> Business Day, 30 Oct 2017.

<sup>42</sup> Business Day, 30 Oct 2017.

<sup>43</sup> Business Day, 13 Nov 2017.

is South Africa's sole power provider and the government has stepped in multiple times in the past five years to bail it out of debt.<sup>44</sup> According to a report commissioned by public enterprises minister **Lynne Brown**, Eskom's reserves were projected to fall to R1.2 billion (\$83m) compared to a target of R20 billion (\$1.3 billion) it reported in its March 2017 year-end report.<sup>45</sup> The report projects that Eskom will enter into R5 billion (\$350m) in negative equity by the end of January 2018.<sup>46</sup> In order to avoid this Eskom will have to reduce its spending by between R5-10 billion (\$350-700m).<sup>47</sup> The report takes the view that Eskom is at risk of failing in 2018 without further intervention by an investor or the state.<sup>48</sup> Responding to the claims, Eskom spokesperson **Khulu Phasiwe** told the media that:

*"We are not insolvent but we are projecting that if we continue along this trajectory we might be in trouble. We as a company need to sort ourselves out and get our house in order so that when we go out to the market to raise money these things do not become a hindrance."<sup>49</sup>*

Eskom needs to raise R54.2 billion (\$3.7 billion) to stay afloat in 2017/2018, but has reportedly only raised 56% of this target.<sup>50</sup> This is already a reduced target, down from R72 billion (\$5 billion) projected in March.<sup>51</sup> Eskom is reportedly trying to raise the funds through bridging loans from commercial banks.<sup>52</sup> The report cites concerns from Eskom's auditors that the ongoing governance issues of the links of senior management to the politically linked **Gupta** family at the heart of the state capture scandal were preventing this.<sup>53</sup> Suspended chief financial officer **Anoj Singh**, former CEO **Brian Molefe** and suspended executive director **Matshela Koko** are all under active investigation in relation to Eskom's dealings with the Guptas.<sup>54</sup> Failure to find funding could lead to a repeat of the power crisis and regular load shedding power cuts South Africa suffered from 2014 to 2016.<sup>55</sup> The **International Monetary Fund (IMF)** estimated that the regular interruptions to power supply due to insufficient capacity at Eskom power plants wiped 1.5% off GDP growth over the two-year period.<sup>56</sup> Eskom is pressuring the **National Electricity Regulator of South Africa (NERSA)** to grant it a 20% increase in electricity prices.<sup>57</sup> Eskom claims that it is unable to grow with the current pricing structure, but NERSA has turned down two applications for tariff increases before.<sup>58</sup>

The most likely option for Eskom remains a direct bail out from the treasury. Gigaba indicated in the MTBPS that the state would not let Eskom go into administration.<sup>59</sup> The impact of Eskom failing to honour its debt commitments or going into business rescue would be disastrous for the South African economy.<sup>60</sup> However, the finance ministry may face liquidity issues itself if it has to bail out Eskom as the MTBPS has already committed finances for SOE bail-outs (see above). Eskom's poor financial situation is a reflection of the economic damage of state capture, draining public funds to cover the costs of illicit enrichment, reducing public spending for years to come, and threatening South Africans with further years of load shedding.

<sup>44</sup> Business Day, 13 Nov 2017.

<sup>45</sup> Fin24, 13 Nov 2017.

<sup>46</sup> Fin24, 13 Nov 2017.

<sup>47</sup> Fin24, 13 Nov 2017.

<sup>48</sup> Fin24, 13 Nov 2017.

<sup>49</sup> Business Day, 13 Nov 2017.

<sup>50</sup> Business Day, 13 Nov 2017.

<sup>51</sup> Fin24, 13 Nov 2017.

<sup>52</sup> Fin24, 13 Nov 2017.

<sup>53</sup> Business Day, 13 Nov 2017.

<sup>54</sup> Fin24, 13 Nov 2017.

<sup>55</sup> ECNA, 14 Nov 2017.

<sup>56</sup> Fin24, 25 Jun 2015.

<sup>57</sup> Fin24, 13 Nov 2017.

<sup>58</sup> Fin24, 13 Nov 2017.

<sup>59</sup> Fin24, 13 Nov 2017.

<sup>60</sup> Source, South Africa analyst, United Kingdom

## Planner

May 2019: Next presidential election

Feb 2018: Finance minister to deliver 2018/2019 budget

17 Dec 2017: ANC *lekgotla* to determine the new president of the party.

30 Nov 2017: Deadline for Jacob Zuma to deliver his submissions to the **National Prosecuting Authority** on the 783 charges of corruption made against him.

## Chronology

22 Nov 2017 **Johannesburg (South Africa)** *Mail and Guardian*. South Africa-based gold and platinum miner **Sibaye-Stillwater** announces the purchase of a 38% stake in tailings specialist **DRDGold**;

20 Nov 2017 Pretoria **(South Africa)** *Business Day*. Director of public prosecutions **Shaun Abrahams** assigns team of specialists from the **Asset Forfeiture Unit (AFU)** to track down the profits of state capture;

16 Nov 2017 **(South Africa)** *Business Day*. **United States**-based investigative reporting group, the **Organized Crime and Corruption Reporting Project**, publishes a report alleging that over 20 banks sent or received money to **Gupta**-family owned companies;

13 Nov 2017 **Johannesburg (South Africa)** *Business Day*. State-owned power utility **Eskom** faces serious liquidity issues in 2018 due to high costs, low tariffs and ongoing politically linked mismanagement;

13 Nov 2017 **Johannesburg (South Africa)** *Business Day*. The treasury confirms the resignation of **Michael Sachs**, head of the treasury's budget office;

8 Nov 2017 **Johannesburg (South Africa)** *Business Day*. Finance minister **Malusi Gigaba** announces that the government plans to sell a stake in state-owned enterprise **South African Airways**;

8 Nov 2017 **Johannesburg (South Africa)** *Press Release*. The **International Monetary Fund** concludes a staff visit, forecasting GDP growth of 0.7% for 2017, which "is not likely to improve much in 2018";

5 Nov 2017 **Limpopo (South Africa)** *Business Day*. Deputy president **Cyril Ramaphosa** announces a slate of running mates for top positions in the ruling **African National Congress (ANC)** December internal elections at a rally in **Limpopo Province**

7 Nov 2017 **Johannesburg (South Africa)** *Bloomberg*. The **Financial Services Board** completes a preliminary investigation into trades of former **Gupta** family-owned **Oakbay Resources and Energy Ltd** shares, and confirms it may seek assistance from foreign counterparts to aid the investigation;

30 Oct 2017 **(South Africa)** *Financial Times*. **Moody's** criticises the government's budget plans, ahead of finance minister **Malusi Gigaba's** February 2018 budget speech;

25 Oct 2017 **Cape Town (South Africa)** *Moneyweb*. Finance minister **Malusi Gigaba** delivers his first medium term budget policy statement, revising growth down to 0.7%;