

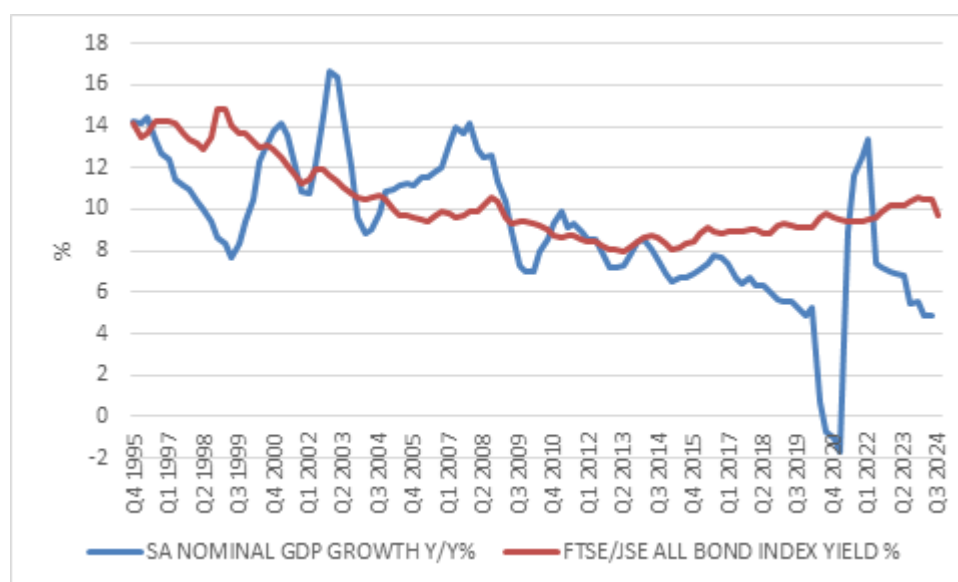
Avoiding fiscal fireworks

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Most people cannot imagine anything more boring than fiscal policy. They are not necessarily misguided. It is usually good when fiscal policy is boring, calm and predictable. Fortunately, that is increasingly the case in South Africa, but not so much elsewhere.

The South African Medium Term Budget Policy Statement (MTBPS), also known as the mini-Budget, updates the numbers presented in the annual February Budget Speech. Budget projections are done on a three-year forward basis, allowing for transparency. There are problems in the South African fiscal landscape, but at least we know about them. Though government debt levels have increased rapidly since 2009, debt itself is not necessarily the biggest problem.

Chart 1: SA nominal GDP growth and 10-year government bond yield, %



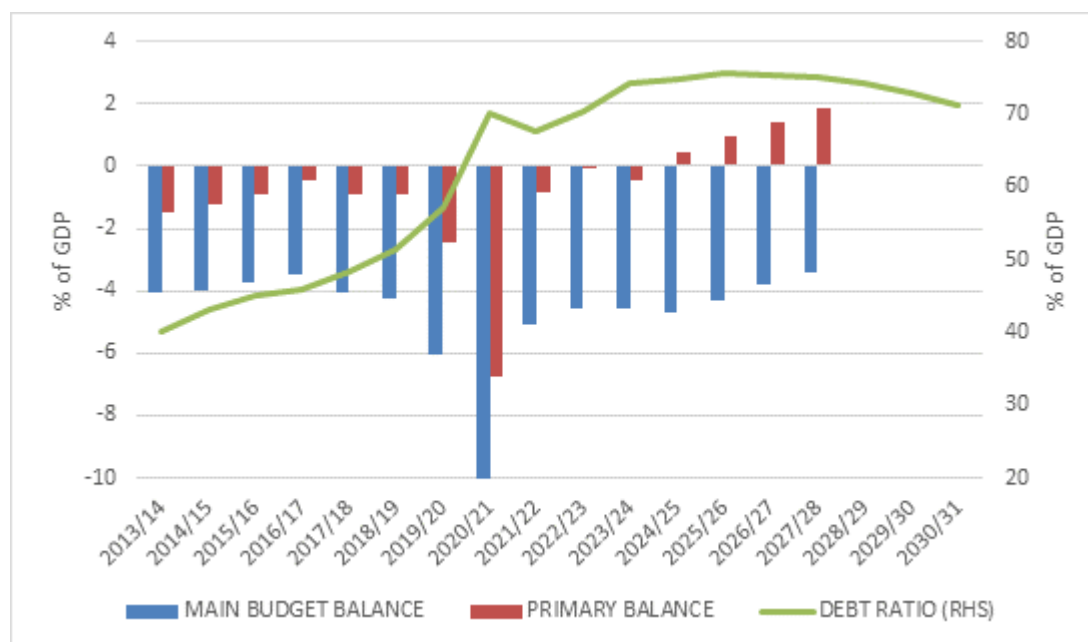
Source: LSEG Datastream

Rather, it is the disastrous combination of low economic growth and high interest rates. Put simply, the government is borrowing at around 10%, but since growth in tax revenues correlates with nominal economic growth, its income has only been growing around 6%. As chart 1 shows, this gap started widening about a decade ago; before then, the nominal economic growth rate was higher than the government's borrowing costs and debt levels were sustainable. But as growth slowed, the market was increasingly concerned about South Africa's fiscal sustainability, pushing up bond yields. Higher borrowing costs in turn put downward pressure on economic activity. This was a vicious cycle that we are hopefully in the early stages of reversing. Bond yields have declined since the election, and growth prospects are higher. Nothing should be taken for granted, however.

The MTBPS somewhat disappointed markets by projecting a wider-than-expected deficit for the current year at 4.7% of gross domestic product (GDP). This is mainly due to tax revenues undershooting by R22 billion. Ironically, lower-than-projected tax revenues are partly due to the improvement in electricity supply. Eskom has been burning less diesel, lowering fuel tax revenues, while import VAT receipts were also lower as imports of solar panels and other electrical equipment have declined.

However, the commitment to fiscal consolidation remains. Treasury will still run a primary surplus this year and over the next few years, meaning tax revenues will exceed non-interest spending. This is projected to result in the debt-to-GDP ratio peaking in the next fiscal year (2025/26) at 75% and drifting lower thereafter.

Chart 2: SA government budget balance and debt as % of GDP



Source: National Treasury (MTBPS 2024)

No, nee, hayi, che

The usual risks to this forecast are there, including public wage negotiations, potential further support for Transnet and other SOEs, and municipal debt to various utilities. Scant provision has also been made for national health insurance. In all of the above, Treasury has gotten better at saying “no,” and when it says “yes” there are conditions. For instance, any further support for Transnet will depend on how the company restructures itself and draws in private investment, while a permanent extension of the Covid-era SRD grant will have to be funded by VAT increases or spending redirected from elsewhere.

A big focus of the MTBPS, rightly, was on raising economic growth rates on a sustained basis, notably through Operation Vulindlela. This joint initiative of Treasury and the

Presidency has had considerable success in tackling obstacles to faster growth, notably in restructuring the electricity market. Its second phase will now focus on local government, addressing spatial inequality, and advancing digital government. The other big area where reforms are underway is the infrastructure development framework, including mechanisms to improve coordination between various parts of government, project preparation assistance, initiatives to de-risk private investments, and streamlining processes for public-private partnerships (PPPs). There is a lot of private capital ready to invest in this space once the groundwork has been laid. Globally, infrastructure is a very popular asset class for pension funds because of its steady and predictable return profile. The same could be true in South Africa.

Despite the economic reforms, Treasury's economic growth assumptions are conservative. It forecasts real GDP growth rising from 1.1% this year to 1.9% in 2027. This suggests that there is room for positive surprises in the years ahead.

Mostly though, the MTBPS was uneventful, which is good. In recent years, budget events had a "now or never" feeling about them, but by now the hard work of bending the debt trajectory through fiscal discipline and removing hurdles to faster growth is well underway. It is just a case of sticking to the plan.

Not smooth sailing

Other countries also face fiscal challenges. The MTBPS coincided with the British Budget speech on Wednesday afternoon. The memory of the disastrous 2022 mini-Budget is still fresh in the memories of investors and commentators. Prime Minister Lizz Truss and Chancellor (finance minister) Kwasi Kwarteng tried to ram through unfunded tax cuts but ultimately lost their jobs after a bond market revolt. It was one of the worst examples of fiscal fireworks in recent decades. For the next few years, it will be the yardstick against which budget announcements will be compared to.

The new Chancellor, Rachel Reeves, the first woman to hold the 800-year old position, inherited a large deficit of 4.4% of GDP, which she also needs to move to more respectable levels over the next few years. The debt-to-GDP ratio is already almost 100%. She announced £40 billion in tax increases, mainly on wealthy taxpayers and businesses, but also £120 billion of new spending, notably on increasing investment and tackling the crisis at the National Health Service. Some have called it a classic "tax-and-spend" Labour budget, and the market response was not positive.

But while both the UK and South Africa are grappling with their respective debt profiles, the same cannot be said of the world's largest economy. Neither candidate in this week's US election have any plans to scale back borrowing. The Republican candidate, former President Donald Trump has promised big tax cuts. Vice-President Kamala Harris, the Democratic candidate, wants to increase spending on infrastructure and social support.

The famous Warton Business School – Trump's alma mater – projects that Harris' policies would add between \$1.2 and \$2 trillion to US government debt over the next decade. Trump's policies, if enacted in full, would raise US debt by a whopping \$4 to \$5 trillion. This is on top of an already rapidly rising debt profile. Chart 3 shows the forecast

from the nonpartisan Congressional Budget Office which is based on current fiscal law. The plans of the next administration will still need to be modelled.

Chart 3: US federal debt-to-GDP ratio, %



Source: Congressional Budget Office

The two candidates are neck and neck according to opinion polls. Statistically, it is a dead heat. However, Trump has enjoyed positive momentum in the polls over the past few weeks and financial markets are seemingly discounting a Trump win. At least that is the narrative that has taken hold on Wall Street in the past few days. Bond prices have fallen, pushing yields higher, pointing to markets pricing in a fiscal deterioration under Republican leadership. At least a Trump victory will not be a surprise to markets.

However, higher bond yields could also simply reflect solid US growth and a recalibration of interest rate cut expectations. The election could go in either direction and the outcome very much depends on what undecided voters choose on the day. The final result might also be in doubt for a while as there are bound to be challenges, recounts or court cases.

One certainty remains, however, which is that US debt keeps rising regardless. It is only a matter of how much. A "sweep" of the White House and Congress by either party means their policy proposals are more likely to be enacted. A divided government means greater deadlock, which, somewhat counterintuitively, markets would welcome as the new president would have to scale back their ambitions.

For now, the ever-rising US debt ratio is not a huge problem. Bond yields have risen but aren't extreme by historical standards. The US government can still easily fund itself, since the market for its bonds is the biggest and most liquid anywhere. Private investors, domestic and foreign, still have a great appetite for what is deemed the safest asset around. Moreover, countries that borrow in their own currencies rarely default.

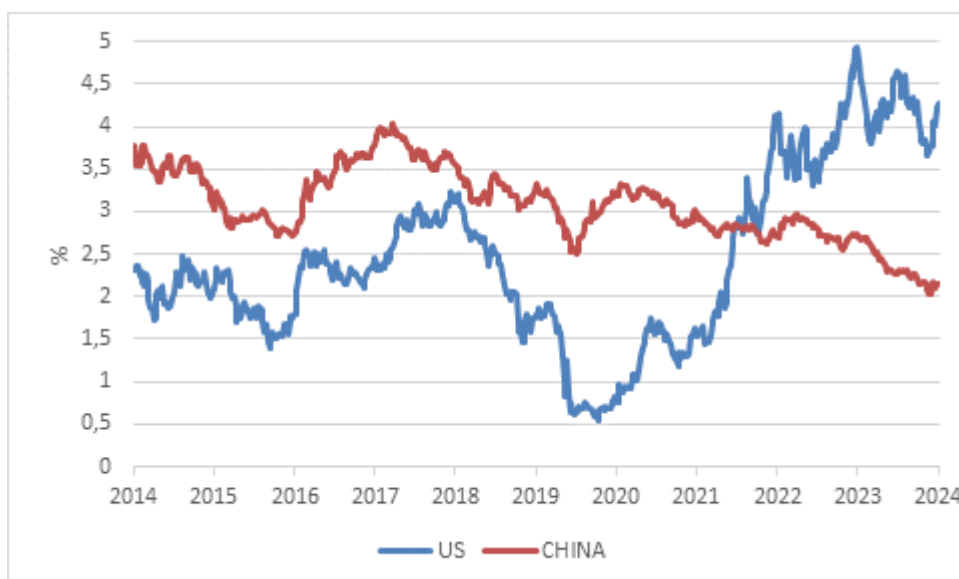
Since US tax revenues are low by the standards of other rich countries, there are options to stabilise debt levels, but no political will. In other words, the problem is not debt per se, but political dysfunction. A crisis is probably needed for a cross-party consensus to tackle the problem. When and how such a crisis arrives is anyone's guess. It will have worldwide ramifications, however, given the special role of US government bonds in the global financial system where they are not just an income-earning asset, but also the main form of collateral that underpins giant funding markets.

Stimulus

On the other side of the Pacific, investors are awaiting news on a fiscal package to stimulate the struggling Chinese economy. News reports suggest that the central government will raise more than \$1 trillion to spend over the next three years, around 60% of which will go towards reducing debt levels at entities owned by local governments (estimated to be as much as \$9 trillion) with the remainder to be deployed in stabilising the collapsing property market.

While the central bank has also cut rates, lower interest rates don't stimulate new borrowing and spending when people are focused on reducing debt. A fiscal injection is needed to raise spending levels and get the economy going again. Unfortunately, this means that a debt problem is tackled by issuing more debt. The government increases borrowing to offset the fact that the private sector cannot or will not borrow more. This has been the historical experience with cleaning up the aftermath of a burst property bubble. As in the US, it poses long-term questions, but unlike in the US, Chinese long bond yields are hovering near record lows. The bond market still expects low growth, low inflation and low interest rates to persist over the next decade. The Chinese government can borrow at historically low rates to fund its stimulus plans.

Chart 4: US and Chinese 10-year government bond yields, %



Source: LSEG Datastream

Finally, returning back home. South Africa is not out of the woods fiscally and will not be until we've had a few years of running primary surpluses and crucially, sustained faster economic growth. But the rest of the world is mostly going in the other direction, with rising debt levels. The International Monetary Fund recently noted that the global government debt-to-GDP ratio will rise to 100% by the end of the decade. It seems unthinkable now, but South Africa might stand out as one of the more prudent countries in two or three years' time, if the Government of National Unity continues to support the Treasury's efforts.

In "normal" situations, stronger economic growth tends to put upward pressure on government bond yields since it implies a rising bias to inflation and interest rates. But that is not the case in South Africa, where weak growth led to insufficient tax revenues and excess borrowing, which can be reversed as the economy strengthens. The same supply-side inefficiencies that caused weak growth have also contributed to higher inflation, meaning that faster growth does not have to imply higher inflation. It means that South African government bonds remain an attractive asset class in a diversified portfolio. The last bit is key, however. In an uncertain world, investors need to be positioned for many different scenarios playing out, not just one (like a certain candidate winning an election).