TOPICAL BRIEFING

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The financial stability considerations of fiscal sustainability

Abstract

The sustainability of fiscal policy in South Africa has been a growing concern in recent years. Contrary to several policy recommendations from multilateral institutions and credit rating agencies,[1] *as well as successive projections by the National Treasury sovereign debt has not stabilised. As a result, South Africa's debt-service costs have steadily increased as a share of the national budget, and have started to accelerate since the synchronised global monetary policy tightening cycle commenced. These developments have far-reaching implications for macroeconomic and financial stability and market resilience.*

This note explores the budget dynamics contributing to the steady increase in South African sovereign debt and debt-service costs despite government's attempt to stabilise the fiscal trajectory. It also analyses the government's debt financing and the financial stability risks associated with the borrowing requirement. Finally, it considers the potential implications related to declining real public investment and social spending amid rising debt-service costs.

[1] See, for example, S&P's November 2019 rating action (https://www.treasury.gov.za/comm_media/press/2019/20191123%20Media%20statement%20-%20S&P%20Global.pdf)

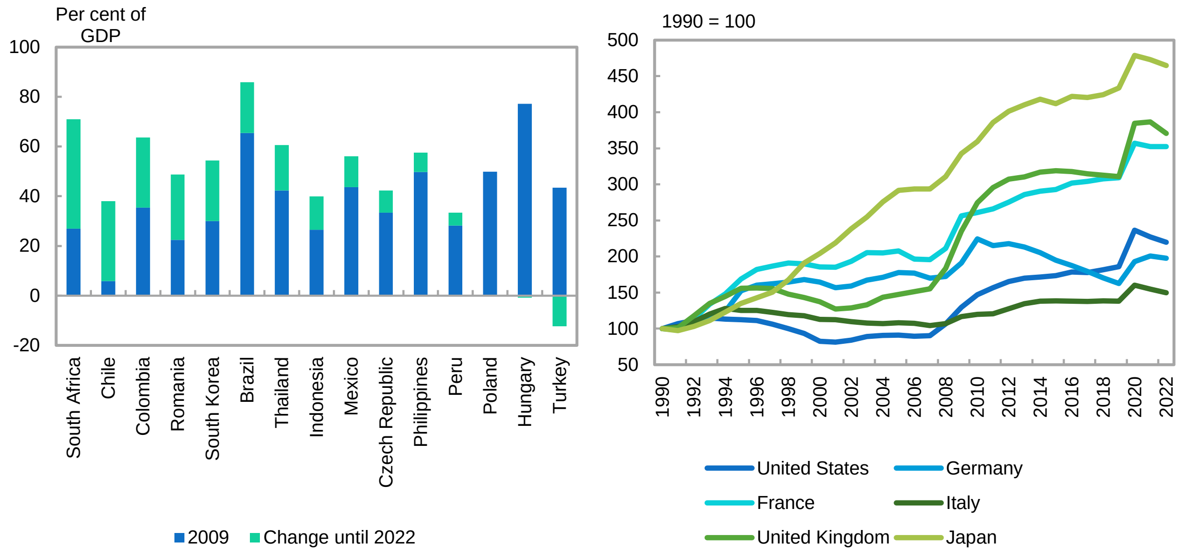
Introduction

A lasting consequence of COVID-19 on the global economy and the financial system has been the pandemic's impact on sovereign debt obligations. The post-Global Financial Crisis (GFC) era of ultra-low interest rates enabled governments of developed markets (DM) and emerging markets (EM) alike to borrow more liberally at lower funding costs, leading to a broad-based rise in sovereign borrowing (Figure 1). Among EMs, the increased access to global capital also contributed to a sharp increase in corporate borrowing, prompting calls for concern from the World Bank by 2020 (World Bank, 2020). For many countries, though, the considerable increase in debt did not raise questions of fiscal sustainability as historically low global interest rates kept debt-service costs under control.

Fiscal policy responses to the COVID-19 pandemic were associated with considerable increases in sovereign borrowing, taking government debt burdens to their highest levels since World War II. A synchronised response among central banks to contain the post-pandemic global inflation shock drove a sharp acceleration in borrowing costs, raising the cost of new debt and increasing refinancing risk for borrowers who would need to roll over existing debt (Figure 2). For higher-risk borrowers, such as EMs, increased risk aversion in line with an interest rate hiking cycle also meant higher risk premia and less foreign investor demand for local currency-denominated debt, further raising the cost of debt. Moreover, fiscal deficits that have persisted since the pandemic have further increased debt-service costs for DMs and EMs alike.

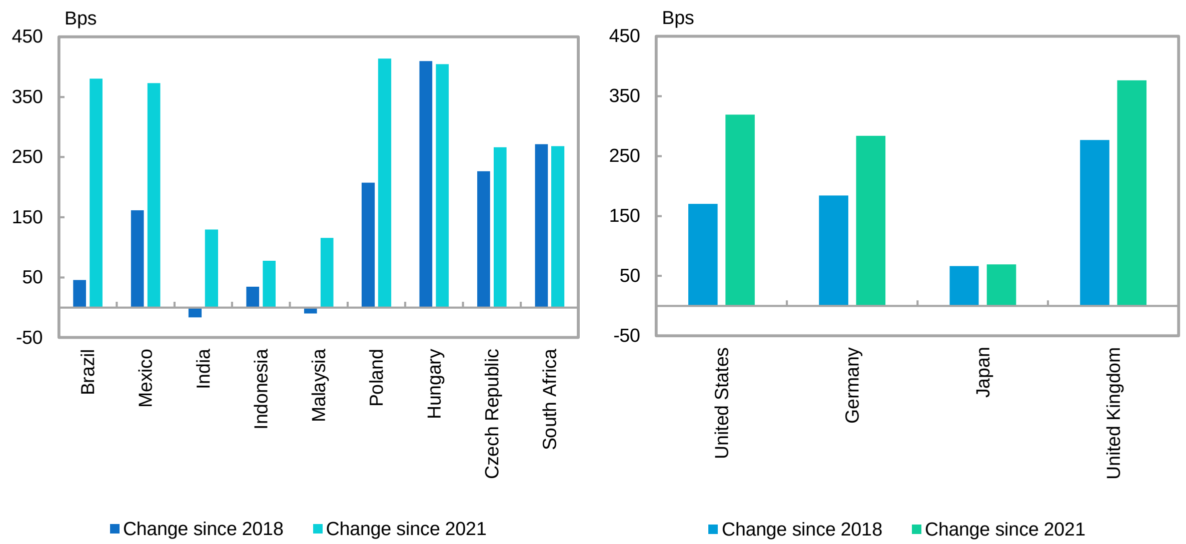
While these global developments have resulted in many countries facing similar fiscal headwinds, concerns about fiscal sustainability in South Africa notably preceded the pandemic-related shocks. As South Africa was among the largest issuers of debt relative to its economy since the GFC, concerns about fiscal risk and sustainability ultimately led to a marked decrease in foreign-investor demand for South African government bonds in early 2018 (Makgopa & Mamburu, 2023). Government's debt-service costs as a share of the main budget revenue increased steadily from 9.75% in 2009/10 to 20.8% in 2023/24, with National Treasury's projections pointing to further increases in this share over the forecasting horizon.

Figure 1: Emerging-market (left) and developed-market (right) sovereign debt



Source: International Financial Statistics

Figure 2: Emerging-market (left) and developed-market (right) 10-year local-currency sovereign yields



Source: Bloomberg Finance LP

The risks associated with a persistently rising debt trajectory are well understood, as much work has been done to analyse the impact of fiscal risk on monetary policy and financial stability risks associated with the sovereign-financial sector nexus, for instance.[2] This work, along with adverse decisions from credit rating agencies in recent years, has led to repeated calls for a stabilisation of sovereign debt.[3] However, this stabilisation has not materialised, even though National Treasury consistently tabled budget projections with a debt stabilising path between much of 2017/18 to 2022/23 (National Treasury, 2017, 2022).

This note explores the budget dynamics contributing to the steady increase in South African sovereign debt and debt-service costs despite government's attempt to stabilise the fiscal trajectory. It considers how the government's fiscal framework contributes to persistent fiscal deficits and an unsustainable debt path. It also analyses the government's debt financing and the financial stability implications associated with the borrowing requirement.

Beyond concerns about market functioning and macroeconomic imbalances, there are other financial stability considerations related to the trajectory of government borrowing and debt-service costs. As has already been observed, rising government borrowing leads to higher debt service costs as a share of total expenditure, crowding out public investment and social spending. Stagnation in public investment in turn contributes to South Africa's existing challenges of low potential growth and increasing structural challenges that further feed into the government's growing debt problem. In turn, real declines in social spending may result in elevated risks of social unrest leading to financial instability.

The fiscal framework and debt sustainability

The topic of fiscal sustainability is largely concerned with the ongoing ability of a government to service its debt obligations with its revenues (Afonso, 2005). Much of the literature regarding fiscal sustainability is concerned with fiscal deficits and the accumulation of sovereign debt. On government borrowing, public finances are considered sustainable when the projected trajectory of the debt burden, often measured by sovereign debt as a share of GDP, stabilises within a forecast horizon (Blanchard et al., 1990). To that end, scholars and policy advice from multilateral

[2] See, for instance, Fedderke (2021), Janse van Rensburg et al. (2022), Hesse & Miyajima (2022).
[3] https://www.fitchratings.com/research/sovereigns/fitch-affirms-south-africa-at-bb-outlook-stable-19-01-2024#:~:text=Fitch%20Ratings%20%2D%20Hong%20Kong%20%2D%2019,%2D'%20with%20a%20Stable%20Outlook

institutions such as the International Monetary Fund (IMF) capture debt sustainability through the interest rate-growth differential:

$$r < g$$

Where the real cost of borrowing, r, is lower than the real growth rate of the economy, g, such that the economy grows faster than the stock of debt and the debt trajectory is contained. Historically low interest rates after the GFC in 2008 meant that the interest rate-growth differential was indeed negative for most DMs and some EMs until the COVID-19 pandemic, despite the general increase in sovereign debt during that period. The growing concerns around debt sustainability since the pandemic are captured in the rise in $r - g$ (Lian et al., 2020).

Related to the cost of borrowing, fiscal deficits also affect the sovereign debt trajectory by determining the amount of new debt that a sovereign must issue to satisfy its budget constraint. In particular, to the extent that a government maintains primary fiscal deficits,[4] it will need to issue new debt in order to finance those deficits as well as service its existing stock of debt. Therefore, persistent primary deficits imply that a government is continually adding to its debt burden over time, while the size of the deficits determine the rate of debt accumulation.

In order to maintain fiscal sustainability, governments may adopt fiscal rules designed to constrain the accumulation of sovereign debt. Typically, such fiscal rules will connect the accumulation of debt to some fiscal anchor, such as imposing a debt ceiling or limits to fiscal deficits (Wyplosz, 2013). The credibility of such a fiscal framework will often rely on the effectiveness of the fiscal anchor (Grembi et al. 2016). For instance, Germany has maintained one of the lowest debt ratios relative to its peers through the constitutional adoption of a fiscal rule that limits the federal government's structural deficit to 0.35% of GDP. This rule, known as the debt brake, is so binding that it has seen successful legal challenges to Germany's federal budget.[5]

4 A primary fiscal balance is the difference between fiscal revenues and non-interest expenditure; a primary deficit materialises when non-interest expenditure exceeds revenues.

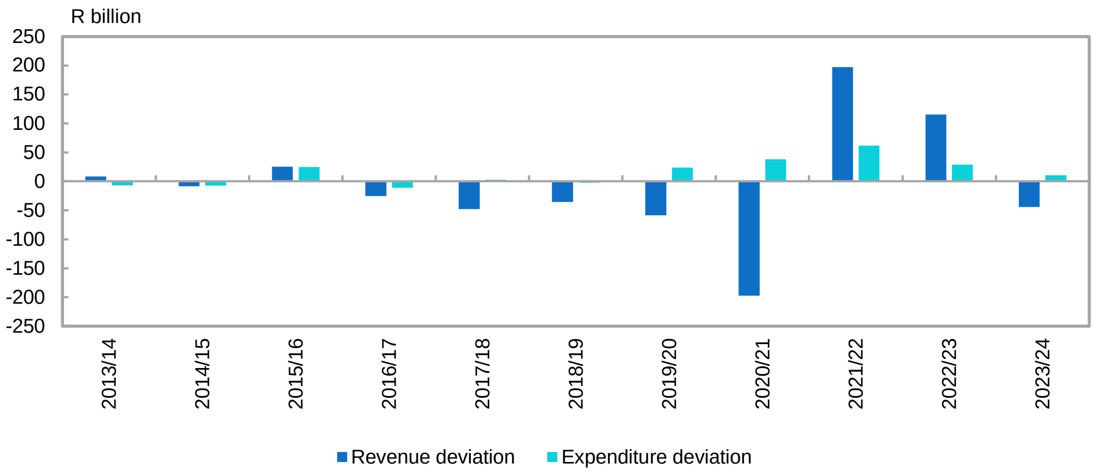
5 https://www.bundesverfassungsgericht.de/SharedDocs/Pressemitteilungen/EN/2023/bvg23-101.html;jsessionid=DD1A322A296C222FF2E7D4AC75E0F256.internet002

South Africa's fiscal framework

South Africa's fiscal framework does not feature a strict fiscal rule, but has rather been based on the use of a nominal expenditure ceiling. The nominal expenditure ceiling is adjusted every year to maintain real fiscal expenditures at a comparable level to when the ceiling was adopted in 2012. Notably, the ceiling is non-binding, in the sense that it can be adjusted upwards or downwards to reflect the fiscal stance or other government priorities that would have an impact on fiscal spending (Soobyah et al. 2023).

In contrast to the discretionary approach employed to determine government spending, projected and actual fiscal revenues are more directly related to domestic and international macroeconomic conditions. To the extent that domestic growth or key external factors such as commodity prices over- or underperform relative to the government's forecasts, revenues will also deviate from their forecasts. Indeed, a common feature of budget outcomes since 2016/17 has been considerable deviations of actual revenues from their projected levels, mostly to the downside. Expenditures, on the other hand, are less responsive to macroeconomic outcomes as they are subjectively determined, such that they deviate from projections to a smaller extent (Figure 3). Moreover, in recent years expenditures have seen upward revisions in relation to unexpected allocations to state-owned entities, such as an allocation of R49 billion to Eskom in 2019/20 announced in October 2019.

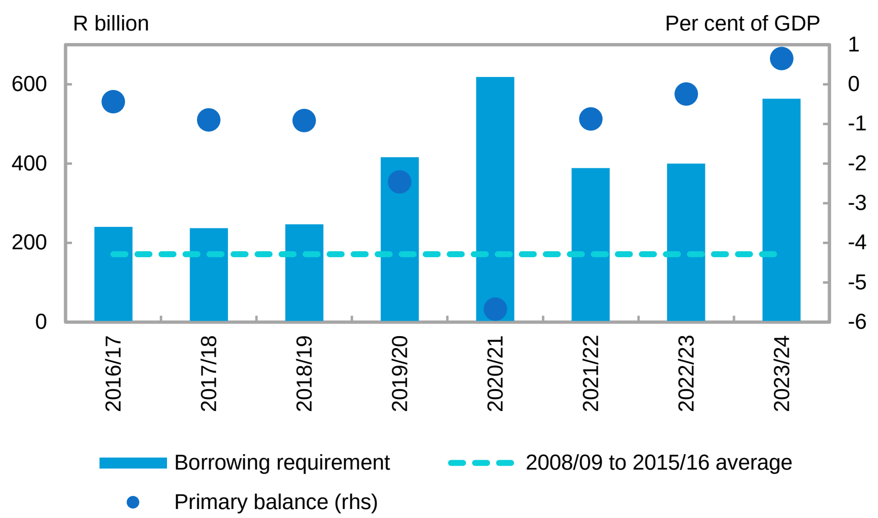
Figure 3: National Treasury revenue and expenditure deviations from forecasts

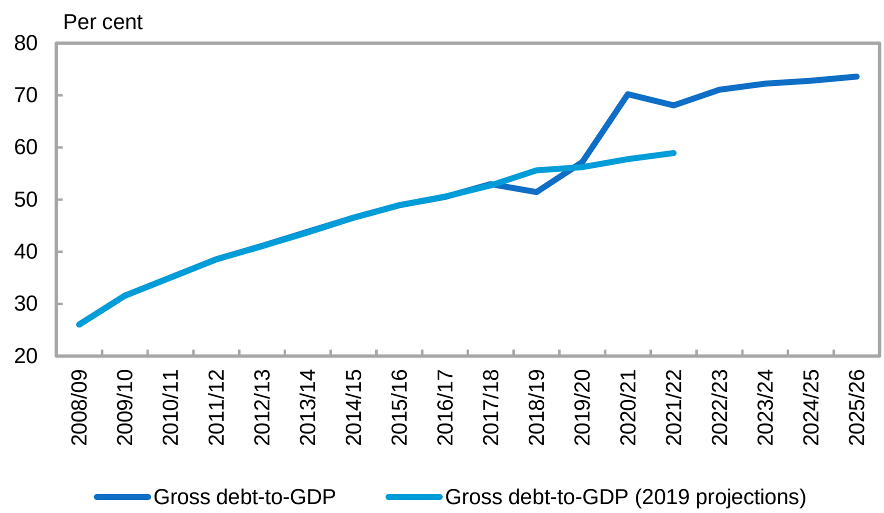


Source: National Treasury

A key consequence of the divergence between fiscal revenue and expenditure outcomes relative to their forecasts is that the government has maintained persistent primary deficits since 2009/10. As shown in Figure 4, these deficits grew since 2016/17 in line with the larger downside surprises in fiscal revenues while actual expenditures were more closely aligned with forecasts. To fund these deficits and debt-service costs, the government's borrowing requirement has also grown over this period, remaining higher than its pre-COVID-19 levels at around R400 billion in 2022/23 even as government revenues exceeded projections by R115 billion. As a result, South Africa's sovereign debt-to-GDP ratio has increased from 31.5% in 2009/10 to a projected 72.2% in 2023/24 (Figure 4).

Figure 4: South Africa's primary balance (top) and sovereign debt (bottom)





Source: National Treasury

Thus, while the expenditure ceiling has determined a path for the growth of nominal expenditure over time, it has not constrained debt accumulation as it does not relate fiscal expenditures to revenues and thus the fiscal balance. To the extent that macroeconomic conditions may adversely affect revenues while expenditures remain at projected levels, deficits are likely to remain a feature of South Africa's budget outcomes, and sovereign debt will continue to grow without decisive intervention by the government.

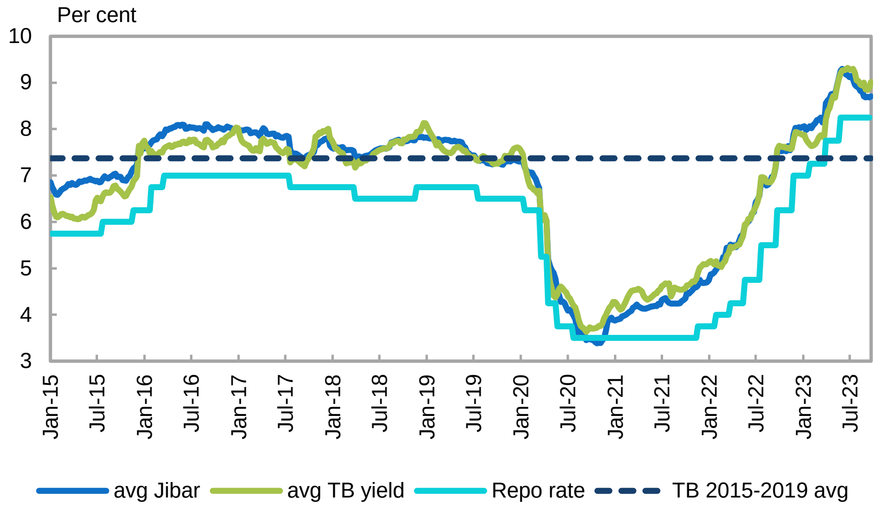
The government's borrowing requirement and debt service costs

Government's borrowing requirement

In order to finance the persistent primary deficit, government relies on debt financing largely through capital markets. In addition to financing the budget deficit, sovereign borrowing also funds government's debt-service costs, which in turn consist of interest payments and the redemption of maturing debt. Effective public debt management aims to raise and manage public debt in a manner that is as cost-effective as possible while minimising the overall level of risk of the government debt portfolio (National Treasury, 2023).

A notable challenge posed by the size and persistence of the South African government's annual borrowing requirement is that it reduces the scope of available options for an optimal financing strategy. In order to minimise the refinancing risk inherent in short-dated debt securities, National Treasury has historically raised the majority of its debt through the issuance of long-term bonds, with Treasury Bills (TBs) comprising around 10% of total domestic debt. While the large increase in the budget deficit following the onset of the COVID-19 pandemic in early 2020 resulted in increased TB issuance, the cost of borrowing in this market did not initially increase in line with the larger stock of short-term debt as interest rates declined substantially from early 2020. As TB issuance has remained elevated in the midst of rising monetary policy rates globally, however, the cost of borrowing in the TB market has contributed to a notable rise in government's debt service costs through rising TB yields since the start of 2021 (Figure 5).

Figure 5: Average Treasury Bill and money-market yields

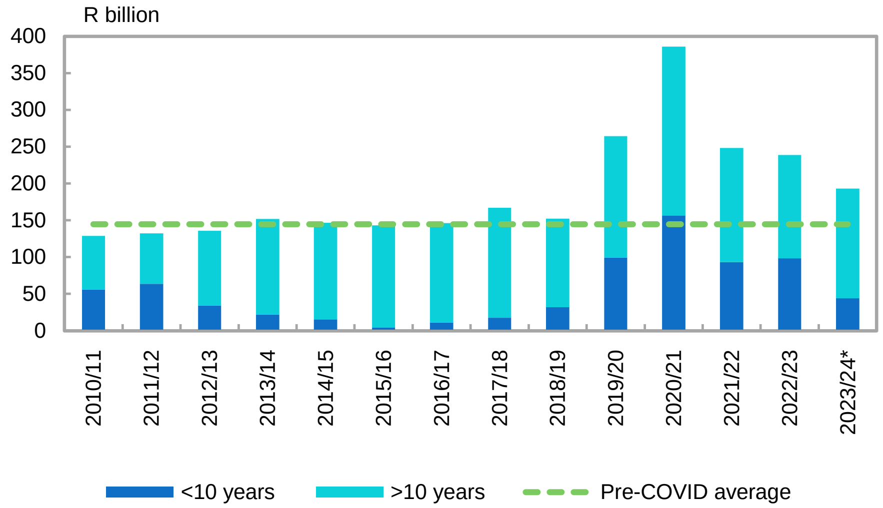


Source: Bloomberg Finance LP, SARB

While National Treasury's overwhelming reliance on long-term bonds minimises refinancing risk and the quick transmission of the policy rate to sovereign borrowing costs, it introduces other risks to fiscal sustainability. As shown in Figure 6, South Africa issues bonds with long terms to maturity, with the average sovereign maturity over exceeding ten years and the longest-dated bond on the sovereign yield curve maturing in 2053. By comparison, EM peers in the JP Morgan GBI-EM Index have an average maturity of under seven years. Fixed-rate bonds with longer terms to maturity have higher interest rate risk, such that their prices are more sensitive to changes in interest rates. In an environment of rising interest rates, a borrower issuing longer-term bonds would have to issue more debt in order to raise a given amount of cash, contributing to a greater accumulation of debt than that of a borrower issuing shorter-dated bonds. Longer-term bonds also have higher coupons to compensate investors for longer holding periods, such that increased reliance on these instruments also contributes to higher debt-service costs.

Taken together, the large size of the government's borrowing requirement means that it must continually raise debt in order to finance its deficit and debt obligations, even when market conditions become unfavourable for a sustained period of time. In the face of rising interest rates, the government is unable to reduce its TB issuance to minimise the impact of the cost of borrowing in the short-term market, or long-term bond issuance to minimise the accumulation of debt amid falling bond prices. The high-level of long-dated debt issuance despite unfavourable market conditions has steepened the sovereign yield curve and raised the risk premium, further pressuring the cost of borrowing. Thus, a large current borrowing requirement feeds into rising debt and debt-service costs and a large borrowing requirement in the future.

Figure 6: South African long-term bond issuance

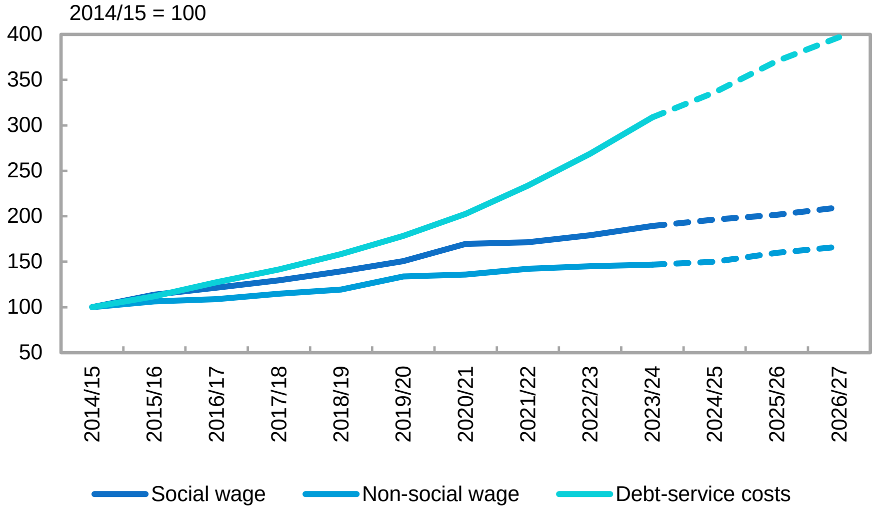


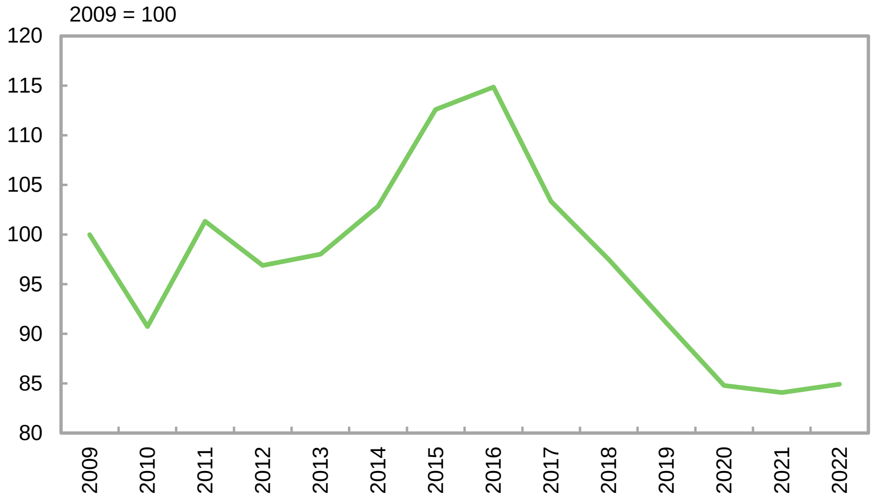
Source: SARB

Government's debt service costs

As the size of the government's issuance in the short-term and long-term debt markets has grown, so costs associated with the government's debt obligations have steadily increased as a share of the national budget. Debt-service costs have more than doubled as a share of fiscal revenue in the post-GFC era, rising from 9.75% in 2009/10 to 20.8% in 2023/24. As the fastest-growing item in the national budget, it has outpaced growth in other fiscal outlays and crowded out growth in both social spending and other non-social government expenditures (Figure 7). Indeed, average annual growth in transfers to households has lagged debt-service cost growth during this period, and has also lagged inflation in the post-pandemic era, with government spending the same amount of money on debt-service costs as social benefits by 2023/24. Meanwhile, real government spending on investment was lower in 2022 than it had been in the year 2009, with its decline commencing in 2016 as revenue underperformance and primary deficits became a central feature of government finances (Figure 7).

Figure 7: Government expenditure (top) and real government capital spending (bottom)





Source: National Treasury, SARB

Government projects that its annual borrowing will remain above R500 billion a year over the next three years. Given expectations that global interest rates will remain higher for longer, debt-service costs are likely to remain elevated. As discussed above, this pressure on the cost of debt obligations is exacerbated by the sovereign's continued reliance on long-dated bonds, which increases the cost of borrowing. In line with this outlook, National Treasury has flagged debt-service cost growth as a cause for concern regarding fiscal policy, as this non-discretionary expenditure is projected to continue growing over the forecast horizon (National Treasury, 2023).

Financial stability considerations

The three most pertinent financial stability considerations with regard to the fiscal sustainability outlook at the current conjuncture are: government borrowing and the sovereign-financial sector nexus; the impact of declining real government investment on structurally low economic growth; and the impact of lagging social spending on social-financial stability risks.

Government borrowing and the sovereign-financial sector nexus[6]

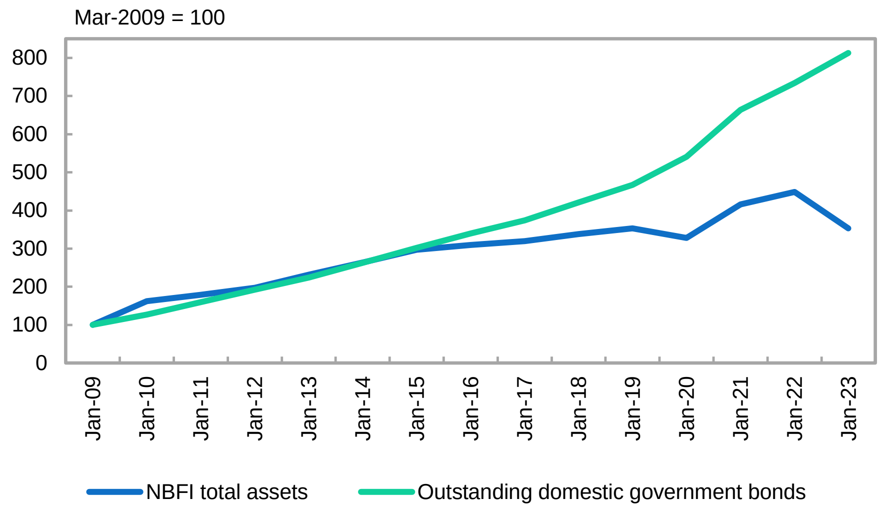
The considerable annual borrowing by the government requires consistent demand in capital markets to absorb a steady supply of government bonds. While non-resident holdings of South African government bonds (SAGBs) increased from R694 billion in December 2017 to R867 billion by December 2023, foreigners' holdings as a share of the total sovereign bond market have steadily declined from 41.4% to 25.3% over the same period in an apparent response to both cyclical and structural factors. The domestic financial sector has thus had to absorb a greater share of sovereign bond supply amid both the declining share of non-resident participation in the market as well as increased long-term bond issuance by the government.

The increasing gross borrowing requirement has contributed to a faster growth in the stock of outstanding domestic government bonds than the balance sheets of domestic banks and non-bank financial institutions, such that a growing share of the domestic financial sector balance sheet has consisted of sovereign bond holdings (Figure 8). This rising exposure to sovereign debt exacerbates the financial stability risks associated with the sovereign-financial sector nexus, which include the impact of a sharp repricing of government debt on domestic financial institutions.[7] A higher concentration of SAGBs on domestic balance sheets also inhibits the capacity of the domestic financial system to absorb shocks such as a sharp sell-off by non-resident bondholders, undermining market resilience. Furthermore, an ever-growing SAGB market relative to domestic savings increases the risk of high-volatility, low-liquidity

[6] See Box 2 of the *2023 FSR Second Edition* for a detailed discussion of the sovereign-financial sector nexus.
[7] See the *2022 FSR Second Edition* for further discussion on risks associated with the repricing of government debt.

episodes in the domestic bond market as well as over-saturation among investors. Taken together, these factors constrain the ability of the domestic financial system to respond to both idiosyncratic and external shocks.

Figure 8: Domestic savings and outstanding sovereign bonds



Source: SARB

Declining real public investment and its impact on economic growth

As noted in past editions of the *Financial Stability Review*, a key risk to domestic financial stability is South Africa's structurally low and inequitable economic growth.[8] The economy's anaemic growth since the GFC has been exacerbated in recent years by structural growth impediments, including an ongoing energy supply crisis and growing operational challenges related to Transnet, the ports and the rail network.[9] Structural reforms and investment in public infrastructure are thus necessary in order to resolve these issues and lift the country's steady state potential growth, which is only 2.5%.[10]

Despite the need for public investment to enhance growth, real government investment spending has declined in recent years as National Treasury has sought ways to mitigate the fiscal impact of revenue underperformance since 2016/17. Gross

8 See, for instance, the *2023 FSR Second Edition* for more details.

9 See IMF 2023 South Africa Article IV Consultation Report.

10 As per the January 2024 MPC published forecasts; see https://www.resbank.co.za/content/dam/sarb/publications/statements/monetary-policy-statements/2024/january/Forecast%20January%202024.pdf

capital spending by government in 2022 was 26% lower in real terms than at its peak in 2016. While these reductions have limited the extent of fiscal slippage in the years since primary deficits became a central feature of the national budget, they have also adversely impacted the economy's potential growth and thereby limited the extent to which fiscal revenues and the primary balance can be improved through a persistently stronger economic growth outlook. In addition, a stagnant growth outlook means that the operating environment of domestic financial institutions will remain weak. A contraction in government capital spending thus poses financial stability risks for both the public and private sector.

Social spending, social instability and the implications for financial stability

As a larger share of fiscal revenues is absorbed by debt-service costs, the initial stagnation and subsequent decline in real social spending have impaired the government's ability to fund the state provision of services such as healthcare, education, housing and social protection.[11] The lack of meaningful employment creation since the GFC has compounded the impact of stagnant social spending as a sizeable share of the country's population of 62 million people remains dependent on the state for the provision of these services. For instance, approximately 54% of the population relied on some form of social transfer from the government by March 2023, including 8.5 million recipients of the Social Relief of Distress grant (SASSA, 2023). This large proportion of the country dependent on state support reflects the deep income and wealth inequality in the country.

Given the extent of inequality in South Africa, the retrenchment of the state from the public provision of services and a social safety net risks a deterioration in social cohesion and a rise in social discontent. Such an increase in social discontent raises the risk of increased incidences of social unrest. Incidences of social instability can also spill over to financial instability and impose costs on the financial system such as increased claims on insurers for associated damages and an increase in uninsurable risks, as seen following the unrest of July 2021. Furthermore, an elevated risk of social instability raises the country risk premium for South African firms and the sovereign in capital markets. Indeed, concerns about risks to social cohesion were flagged in the

[11] These categories of expenditure constitute what National Treasury refers to as the 'social wage' in publications such as the 2023 Medium Term Budget Policy Statement, along with expenditure on employment, transport and local amenities.

International Monetary Fund's 2023 Article IV Consultation with South Africa (IMF, 2023).

Conclusion

In recent years, South Africa's public finances have been characterised by persistent primary deficits, a growing annual gross borrowing requirement, and a failure to stabilise sovereign debt. This has in turn resulted in debt-service costs growing notably as a share of main fiscal revenues at the expense of other forms of fiscal expenditure including social and investment spending, enhancing the risks associated with sovereign-financial sector nexus, risks related to structurally low growth and social-financial stability risks emanating from stagnant social spending.

In order to address these macro-financial stability risks, South African sovereign debt needs to be stabilised. To stabilise sovereign debt and contain debt-service costs in the medium term, the government must be able to produce credible and consistent primary surpluses. To do so, a robust fiscal framework with a credible fiscal anchor is necessary. Such a fiscal anchor would align both fiscal revenues and expenditures with macroeconomic conditions to limit the incidence of adverse surprises in the primary balance. Consistent primary surpluses would also allow the government to focus on adopting strategies to reduce the stock of sovereign debt such as redeeming upcoming bond maturities rather than employing switch auctions, thereby gradually reducing the burden of debt-service costs on the fiscus.

In the near term, however, amid a highly uncertain global interest-rate backdrop, a large existing stock of sovereign debt and upcoming bond maturities, debt-service costs are set to remain elevated. The government borrowing requirement is also likely to remain elevated given the outlook for debt-service costs, intensifying the exposure of the financial system to the sovereign. A credible fiscal anchor is thus urgently necessary in order to rehabilitate the primary balance and achieve macro-financial stability over time.

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