Objectives, current & medium-term Debt Strategy

• **Before 1999:**
  - Develop the domestic market
  - Promote a balanced maturity profile

• **After 1999:**
  - Reduce cost of debt within acceptable risk limits
  - Ensuring government access to domestic and international financial markets
  - Diversify funding instruments

• **Since 2005 - Links to Funding Strategy & Fiscal Policy objectives:**
  - Annual funding strategy underpinned by risk guidelines
  - Debt structure (composition) - insulate annual budget from volatility in interest expenditure caused by interest, inflation and exchange rates
  - Debt structure - assist in realising government’s fiscal policy objectives of debt sustainability and intergenerational fairness
Background: Introduction of Inflation Linked Bonds in South Africa

- Government issued first inflation linked bond (13 yr. 6.25%) in March 2000
- Currently government issues in the following maturities: 5 yr, 7 yr, 10/11 yr, 15 yr, 20 yr, 28 yr, 32 yr
- South Africa even issued a 3-legged ILB with split-maturity 2049/50/51
- The structure of South Africa’s inflation linked bonds is principal indexation - no interest indexation
- Funding share is 20% of annual domestic long-term funding (excluding Treasury bills) and 17.6% of overall domestic funding (including T-bills)
- Portfolio share of 20-25% informed by the 2014-15 benchmark exercise

<table>
<thead>
<tr>
<th>Risk Benchmark Indicator</th>
<th>Type of Risk Indicator</th>
<th>Numeric Risk Benchmark (Outcome)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Share of debt maturing within a year (including T-bills)</td>
<td>Short-term Refinancing Risk - LIMIT</td>
<td>15% of total domestic debt</td>
</tr>
<tr>
<td>2. Share of debt maturing in 5 years (Fixed Rate Bonds and Inflation Linked Bonds)</td>
<td>Refinancing Risk - LIMIT</td>
<td>25% of total domestic debt</td>
</tr>
<tr>
<td>3. ATM - (Fixed Rate Bonds + T-bills)</td>
<td>Refinancing Risk - RANGE</td>
<td>10-14 years</td>
</tr>
<tr>
<td>4. ATM - Inflation Linked Bonds (ILBs)</td>
<td>Refinancing Risk - RANGE</td>
<td>14-17 years</td>
</tr>
<tr>
<td>5. Share of ILBs as per cent of domestic debt</td>
<td>Inflation Risk - RANGE</td>
<td>20-25%</td>
</tr>
<tr>
<td>6. Share of Foreign Debt as per cent of Total Debt</td>
<td>Currency Risk - LIMIT</td>
<td>15%</td>
</tr>
</tbody>
</table>
Background: Introduction of Inflation Linked Bonds in South Africa

### Benchmark Indicators

<table>
<thead>
<tr>
<th>Benchmark Indicators</th>
<th>Range or limit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share of short-term debt maturing in 12 months (Treasury bills) as a percentage of total domestic debt</td>
<td>15% 13.02% 12.84%</td>
</tr>
<tr>
<td>Share of long-term debt maturing in 5 years as a percentage of fixed rate bonds and inflation linked bonds</td>
<td>25% 11.77% 9.15%</td>
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<tr>
<td>Share of inflation-linked bonds as a percentage of total domestic debt</td>
<td>20-25% 22.58% 22.91%</td>
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<tr>
<td>Share of foreign debt as a percentage of total government debt</td>
<td>15% 8.86% 10.26%</td>
</tr>
<tr>
<td>Weighted term-to-maturity (fixed-rate bonds and Treasury bills in years)</td>
<td>10-14 13.49 13.58</td>
</tr>
<tr>
<td>Weighted term-to-maturity (inflation-linked bonds in years)</td>
<td>14-17 14.92 14.44</td>
</tr>
<tr>
<td>Average term-to-maturity (total government debt in years)</td>
<td>15.25 13.48</td>
</tr>
<tr>
<td>Average term-to-maturity (foreign debt in years)</td>
<td>9.19 11.03</td>
</tr>
</tbody>
</table>
Rationale for issuing linkers

- In the National Treasury research conducted in 1999, it was observed that a number of countries that successfully issued ILBs went through roughly similar checklist:
  - Choice of index
  - Size, frequency of issuance and primary dealership system
  - Liquidity
  - Pricing and tax issues
- Strong macro policy case:
  - Signaling of intention to control inflation
  - Demonstrate government’s commitment to prudent macroeconomic policies
Rationale for issuing linkers

- **Strong debt/fiscal policy case:**
  - Government saves the risk premium over time and pay actual inflation, which is even back loaded than the excessive market premium priced in conventional bonds
  - Government’s willingness to assume financial risk of inflation, while transferring the market (making) risk of conventional bonds to the market
- **Asset Liability matching case:**
  - Holdings of ILBs by pension funds have increased, while that of conventional bonds has decreased
Developments in the Debt Exposure

Share of ILBs (%)

Refinancing within 5 years (%)


Share of ILB as a % of domestic debt
Foreign debt as a % of total state debt
T-Bills as a % of domestic debt
Developments in ATMs of ILBs, FRBs/TBs
Market for Linkers

- Annual turnover in ILBs is about R325 billion compared to R6.4 trillion in conventional bonds.
- Turnover as percent of outstanding is spread out for ILBs.
- The R197 (2023) and R202 (2033) have been off-the-run and closed for issuance in excess of 5 years due to high index ratios, only recently (September 2018) has the Treasury reopened them due to need to meet cash targets.
Market for linkers cont’d

- Since October 2005 linkers were auctioned on a uniform price basis
- No appetite from investors for liability management operations with respect to linkers
- Similar to Treasury bills linkers have no primary dealers appointed and compelled to submit bids in the primary market on a weekly basis
- This poses a risk of auctions not being fully subscribed
- Taking part in weekly linker auction is open only to members of the Johannesburg Securities Exchange (JSE)
- The breakeven inflation rate in the 7 year maturity is decreasing but above the actual inflation rate
Possible drawbacks?

• **Investor Base:**
  o Pension funds hold between 40% and 60% of linkers compared to between 2% and 25% in conventional bonds
  o Of the 40% SA bonds held by foreign investors, linkers comprise a small percentage (1% to 7%)

• **Lengthening the curve:**
  o No constraints on lengthening nominal curve, except dispensing with the old practice of overlaying maturities (linkers redeeming same maturity as nominals)
  o The real challenge with relatively longer linkers is the higher index ratios

• **Inflation Index:**
  o The SARB dispensed with CPI-X and used the same (headline) inflation index as that used for linkers
Thank You