Is South Africa approaching a fiscal cliff?



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In this article, we unpack what a debt default is, what it looks like, whether or not it can be alleviated and then provide our view of the South African Government's willingness to change the current trajectory.

Sovereign debt default?

Occurs when a government no longer makes good on its debt obligations to its creditors and originates either due to over indebtedness or a purposeful strategy of not paying debts back.

Are debt defaults common?

- Yes, Venezuela and Ecuador have both defaulted 10 times
- Brazil 9 times
- Spain has defaulted 13 times (over the last 300 odd years) - 7 times (19th century) & 6 times (18th century)
- Italy defaulted during World War 2 and China in 1921

The latest newsworthy default occurred in May 2020, when Argentina failed to pay a US$500 million foreign loan and is negotiating to restructure US$66 billion of external debt. South Africa (SA) imposed a 'debt standstill' in 1985 after PW Botha's infamous Rubicon Speech – we are thus not total newcomers to debt delinquency.

The framework applied by BlackRock to predict credit defaults captures the clear warning signs. The BlackRock Sovereign Risk Index assesses the credit risk of 60 countries, based on 30 measures and these effectively monitor four broad parameters:

1. Fiscal space – a country's ability to budget avoiding excessive debt. *SA scores poorly.*
2. Willingness to pay – the cultural attitude to paying debts as well the ability to do so. *SA scores poorly.*
3. External financial position – how much the country is exposed to external macro factors. *SA is slightly better here, but still poor.*
4. Financial sector health – financial sector poses a threat to its credit worthiness. *Unsurprisingly, SA scores positively here.*

SA ranks 47th of the 60 countries, a significant weakening from 33rd in 2013. The top three are Norway, Switzerland and Singapore, whilst Lebanon, Venezuela, Argentina and Egypt are most at risk. With the exception of the cushion of parameter four, which is well known and understood, we assess SA against each point and conclude.

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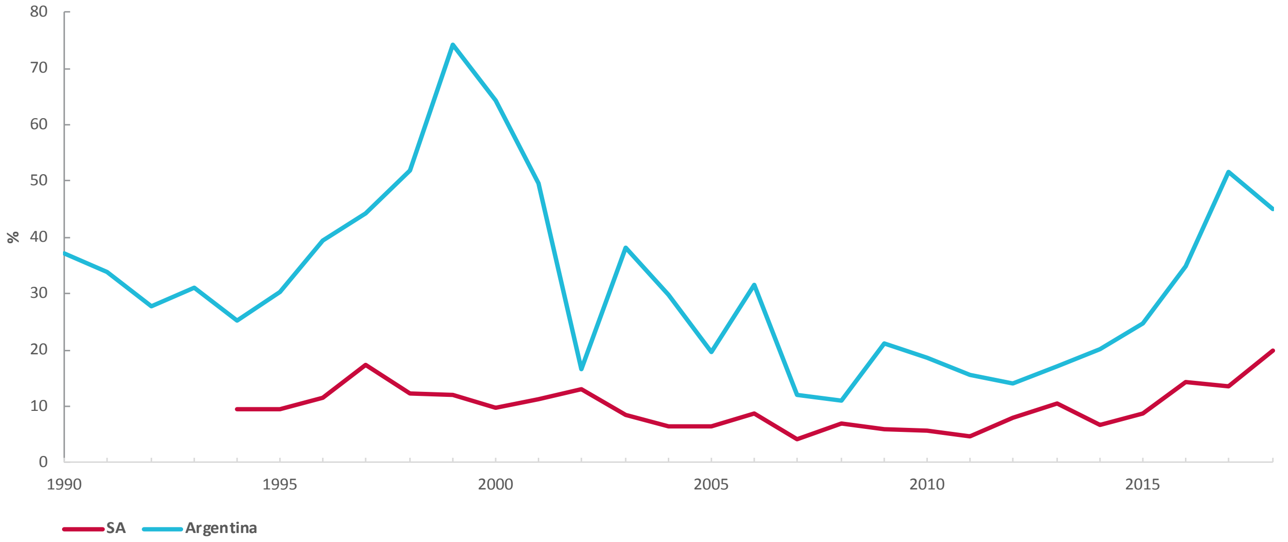
1. Fiscal space

After assessing most developed and developing countries by calculating their revenue* versus debt servicing costs, it becomes apparent that once this ratio exceeds 20%, countries enter a period of fiscal strain. Chart 1 below shows how SA has started to track Argentina's profile, well before Covid-19.

Chart 1: Total debt service (% of exports of goods, services and primary income)

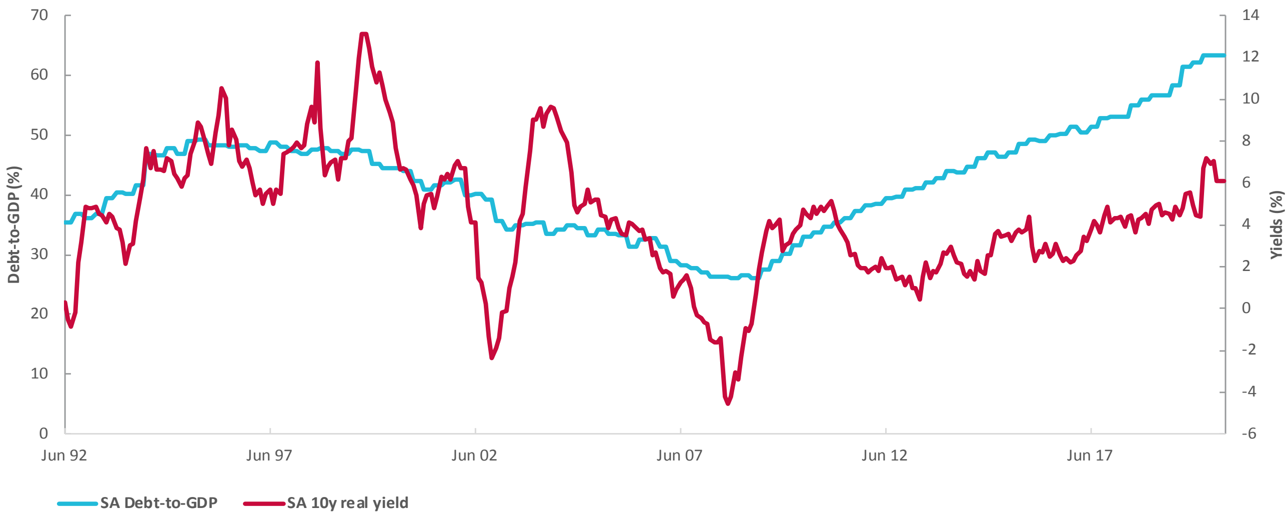


Source: World Bank, International Debt Statistics. SA data available from 1994 (August 2018)

SA debt servicing costs are escalating for two reasons:

1. SA forecasts for 2020 include R1.1 trillion revenue and R1.8 trillion expenditure. The huge deficit of R0.7 trillion can only be financed with debt. Gross debt will grow 21% from R3.3 trillion at the start of 2020 to approximately R4.0 trillion by the end of the year, comprising 82% of annual GDP.
2. With global interest rates at record lows and financial markets passively allowing most fiscal deficits to be funded, the market's requirement for increased SA rates reflects the resultant risks from unfettered spending and ensuing uncontrolled increases in debt.

Chart 2: SA 10 year real yield vs Debt-to-GDP



Source: Iress & Northstar (31 August 2020)

*What the Government collects through taxes.

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Debt used to fund productive activities including for example infrastructure, is understandable. Unfortunately, in SA, it is being used to sustain an unproductive and bloated public work-force, finance uneconomic SOE's and is exposed to graft. Our concern is shared by foreign investors who, on a net basis, sold down R88bn bonds and R53bn equities in the first half of 2020.

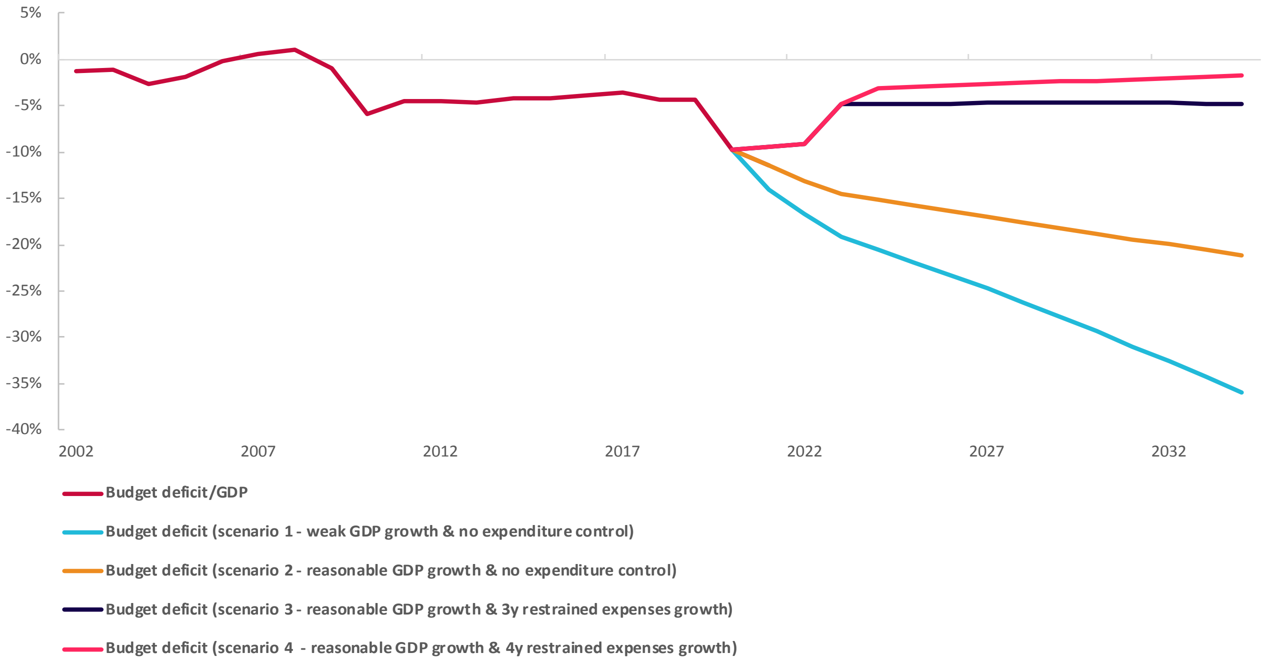
What will SA's fiscal discomfort lead to?

We model three scenarios in Chart 3 below:

1. Spending continues unabated and the economy remains weak (blue line), resulting in a staggering 35% budget deficit.
2. Ongoing spending spree but the economy starts to grow. Here, the deficit rises, reaching almost 25% (orange line).
3. Expenses reigned in, whilst GDP increases. Normality ultimately returns to domestic public finances.

Historically, cost control has only been given lip service and the consequence is that SA's debt position has only worsened and the orange line reflects this trajectory. Hopefully government understands what is at stake and the necessary reforms are put in place.

Chart 3: Budget deficit/GDP



Source: National Treasury, Northstar (31 August 2020)

2. Willingness to pay

Argentina has defaulted 9 times, since independence from Spain in 1816. SA has only done so once to date. Looking forward, SA does not lend itself to austerity economics, possessing bloated public services and rigid unions, not dissimilar to Argentina. Our guess is that populist politics will win out against conservatism in debt management.

3. External financial position (offshore debt as a percentage of total public debt)

An important distinction between SA's public finances and Argentina's, is that the proportion of foreign or hard currency debt relative to total debt in SA is small, about 10%, whereas the majority of the US$285 billion owed by Argentina is denominated in hard currency.

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As evidenced on the previous page, higher levels of indebtedness force higher interest payments for governments. In foreign currency, this challenge is only compounded by currency depreciation multiplying the interest payment burden. This ultimately breaks the back of indebted countries, the story of Argentina.

SA does not face this exact issue, yes our escalating indebtedness is causing interest rates to rise and so too resulting in Rand weakness, but foreign debt repayments will not be our undoing.

Where to from here, the transmission mechanism in SA

Our view on SA's glide scope:

- Debt will rise, and creditors will increasingly be unwilling to fund SA's bulging deficits.
- Interest rates will continue to rise compensating for default risk.
- The Rand will weaken precipitously, resulting in inflation ballooning with short-term interest rates skyrocketing.
- The economy will experience a severe contraction, greater than anything we have witnessed before.
- How the fiscus then honours debt obligations is a thought piece deserving its own article, but what is clear is that few options are economically friendly in the short to medium-term.

The South African economy is in poor shape and we face numerous complex economic headwinds which include an elevated Gini coefficient, substandard education levels and rising unemployment. Consequently, our citizens are vulnerable and the current misdirected economics are compounding this sorry state.

In conclusion, our article has not sort to answer or for that matter solve the, "unanswerable", moral and symbolic arguments of the SA government's populist tendencies; this we leave in the hands of political analysts and politicians. What we base our conclusion on is empirical data together with the historical trend we are observing being played out in SA. Our view is that the SA government has little choice but to actively reduce public expenditure, redirect the remaining budget to productive assets and cultivate a business friendly environment.

"Widespread intellectual and moral docility may be convenient for leaders in the short term, but it is suicidal for nations in the long term."
— Carl Sagan

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