A Sovereign Debt Crisis?

"Here, for all the difficulty and human tragedy around the pandemic, this is a well understood shock. It's not hard to see that a disease has descended upon us and is causing havoc." - James Bullard, President of the Federal Reserve Bank of St Louis

As the second half of 2020 kicks off, the hope of a COVID-19 vaccine is helping to defuse risk aversion. For South Africa, a wave of business failures owing to the pandemic could still trigger a financial crisis. Even though the initial wave of the March-April lockdown has passed, the disease is still quite capable of surprising us all. The South African government implemented one of the most draconian lockdowns in the world, resulting in a huge economic cost. Restrictions to curb the spread of COVID-19 halted almost all activity in April and were only gradually lifted in May. Gross Domestic Product shrank an annualised 2% in the three months through March, compared with a 1.4% decline in the final quarter of 2019. This is the first time since 2009 that a South African recession has lasted longer than two quarters, and the contraction will probably continue, and deepen, in the three months through June. As such, the South African economy probably contracted in excess of 30% on an annualised basis in the second quarter, the most since at least 1990. According to a survey conducted by Bloomberg. It is likely that we will see the economy contract 6.9% in 2020, expand 2.7% in 2021 and 1.8% in 2022.

Supporting the economy

For some observers, the stimulus measures to support growth, meanwhile, have been too small and come too late. Large scale business closures and job losses mean the recovery will likely be slow and partial. Companies in the aviation, construction, and entertainment and hospitality sectors have indicated plans to cut jobs due to heavy losses experienced in the past few months. In addition, small companies are being hard hit and some businesses are closing down permanently. Mores worrisome, South Africa's unemployment rates has pushed pass 30%. The unemployment rate has remained above 20% for at least two decades, largely due to structural barriers, including the education system. For a country which was already facing an unemployment crisis and weak economic growth, difficult decisions and difficult times lie ahead.

"For want of a nail the shoe was lost. For want of a shoe the horse was lost. For want of a horse the rider was lost. For want of a rider the message was lost. For want of a message the battle was lost. For want of a battle the kingdom was lost. And all for the want of a horseshoe nail."

We are reminded by the quote by Benjamin Franklin, the words demonstrate the simple fact that each of our actions, no matter how unimportant we think they are, will have a consequence. Sometimes, something as insignificant as a nail could cause such a big trouble like the loss of a kingdom. The broader erosion in institutional strength induced by the wide-spread corruption of the Zuma administration is an important factor behind the erosion in South Africa's credit profile in recent years. Moreover, the legacy that era has bequeathed of poor governance of state owned enterprises remains a key drain on fiscal resources. With the loss of the last investment rating and South Africa's subsequent expulsion from the FTSE WGBI behind us, it seems that the Rand's 'idiosyncratic' risks have receded. Yields on South Africa's most liquid bonds (see Figure 1) have rallied to around five year lows.

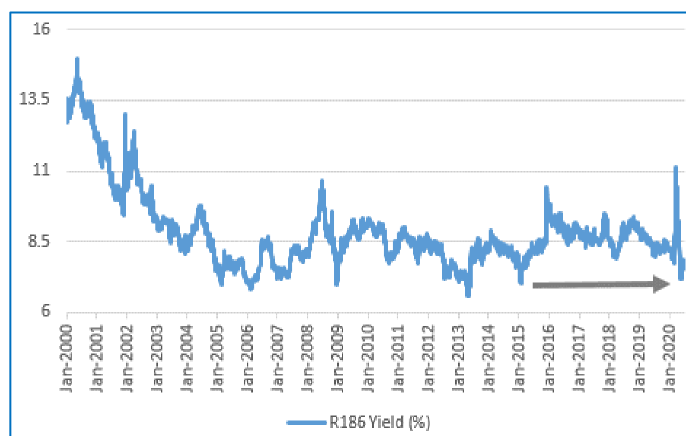

Figure 1. Yield on the R186 government bond, IRESS

Support measures will blow out the budget deficit, the largest in at least three decades. The country intends borrowing $7 billion from international financial institutions including the IMF to support the pandemic response. It has already secured a $1 billion loan from the New Development Bank. The country is already borrowing at a rate of more than R1 billion a day, but even that may not be enough to plug a hole in government finances. This is as much as 15% of gross domestic product, which is more than double the 6.8% shortfall that was projected in February. National Treasury is forecasting a main budget deficit in the current fiscal year of 14.6% of GDP.

Government debt is likely to surge to 81.8% of GDP in the 12 months through March 2021 and continue rising to peak at 87.4% of GDP in 2023/24. This is only possible if the government takes active steps to manage its finances. Failing that, the debt trajectory will keep rising, topping 140% by the end of the decade. With a debt to GDP ratio that's expected to exceed 100% by 2025, the state has little room to fund infrastructure despite South Africa's need for everything from power plants and broadband to additional housing and water supply. State companies also have limited scope to fill the gap because they too already saddled with billions of dollars of debt. South Africa's finances are in pretty dire shape. We have had a lost decade courtesy of "Zumanomics". As such, the country remains at risk if global markets sell off.

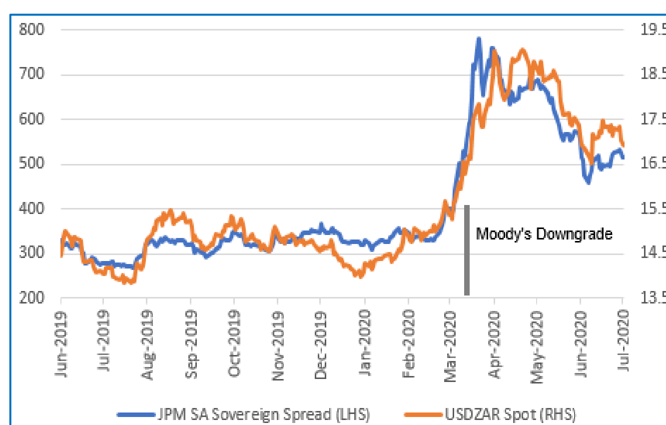

Figure 2. Rand-dollar movement (RHS) and SA sovereign credit spreads, Sanlam Investments

The current revised budget adopts a relatively optimistic picture, as its baseline is established mainly on the hopes of a change to zero-based budgeting. But could the zero-based budget be a backstop before a spiralling debt crisis? The plan envisions spending reductions and revenue adjustments amounting to approximately R250 billion over the next two years. Although markets responded positively, Treasury's overall outlook is too optimistic especially the ambitious plans

to cut the deficit. By consolidating too soon and too aggressively, the Treasury will undermine the economic recovery and increase the risk of a future debt crisis. The country's total debt is approaching R4 trillion, a first in history.

As a result of inadequate stimulus, economies like South Africa are positioned for an extended slump, not a rapid recovery. Rising debt service costs will continue to make up a disproportionate share of their budgets, squeezing room for social development spending.

The ideal response is big stimulus now and a credible commitment to cuts and reform later. But the stimulus is too small to support the recovery, and reform and consolidation are unlikely to happen. Therefore, it is unlikely that the debt trajectory stabilises anytime soon. The Rand weakened following the Moody's downgrade to a record R19.35 per dollar, but has rebounded more than 10% since then. PPP is circa R13.95-14.00 per dollar. To some extent, South Africa's risk metrics and the Rand have improved since the downgrade. After selling a record R64 billion of South African government bonds on a net basis in the five months through May, foreigners are buyers again. Inflows for the month until 24 June 2020 totalled R9.24 billion. Bond yields have room to move lower as inflation remains subdued due to low oil prices and the pandemic-induced decline in consumer demand.

Due to the considerable uncertainty over the path of the outbreak and economic recovery, the risks to the outlook are skewed to the downside. It may take a while for the Rand to complete a rebound from April's record weak levels relative to the dollar. There is a high likelihood that the Rand gradually appreciates against the dollar over the next 12-18 months, but patience is warranted. South Africa must cut spending to avoid a sovereign debt crisis.

Sovereign debt crisis

"A sovereign debt crisis is a very serious matter and we are looking it in the eye by 2024 if we do not redo our budget, if we do not manage our house finances carefully" - Minister Tito Mboweni

SA was already running 'crisis-level deficits' before the virus hit and the pandemic is resulting in additional fiscal deterioration. Despite the looming sovereign debt crisis, there is still lack of certainty around what it will take to get the economy going again. Government must however show even greater commitment to creating an enabling economic climate and destination, and significantly reduce non-interest expenditure. The case for reform in South Africa is now more than urgent given the biggest challenge to the country's debt outlook is weak underlying structural growth. In the absence of credible growth reforms, the tax base will narrow further, widening the deficit with additional spending cuts. More state owned enterprises will need to be bailed out and the cost of servicing debt will become higher. While the country can still afford to service its debt, it will eventually hit a wall if economic growth is not lifted or expenditure drastically cut.

Treasury has warned that an absence of fiscal space would leave the country vulnerable to external shocks. This has now unfortunately become a reality. As such, this is the risk captured in the downgrade, sovereign spread, the currency, and the extent to which long dated bond yields have pushed higher. Even if it were possible to aggressively narrow the budget deficit, it will most likely be a headwind on economic growth. Treasury is budgeting for a R350 billion plunge in tax revenues this year due to the fall in VAT and personal income tax required to support the extra expenditures in health care and across provinces. Minister Mboweni has however warned that the country could slump into a sovereign debt crisis over the next 5 years if no action is taken. Cutting through the noise, government must rapidly reduce spending and speedily enact economic reforms. Subsequently, if left unchecked, the interest payments on growing debt pile will become one of government's largest expenditure items over the medium

term. The country is well on its way along a 'fiscal tightrope', and if we remain passive, we approach a 'failed state' plagued with stagnant economic growth, a debt spiral and interest payments that crowd out spending on socio-economic priorities.

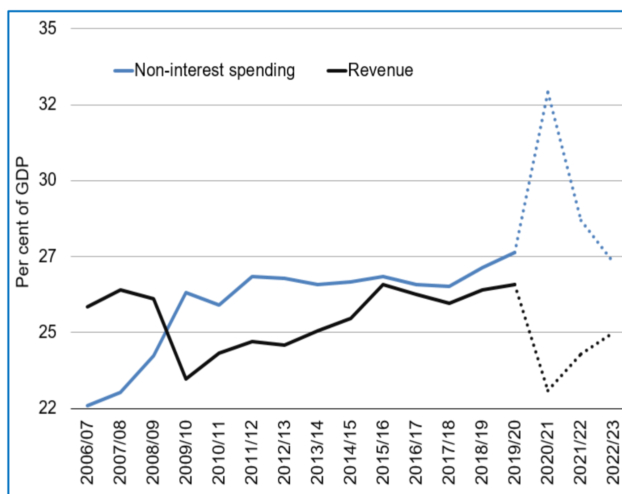

Figure 3. Non-interest expenditure vs revenue, National Treasury

Responding to the pandemic with a huge spending plan was always going to be difficult given the precarious position South Africa was already in. By opting against injecting new stimulus in preference for cutting expenditure, the Treasury has pushed the country one step closer to a debt crisis.

While the current plan ostensibly preserves fiscal sustainability, it actually undermines it by weakening the recovery.

Government is spending far more than it collects in revenue. As a result, debt has mushroomed. A failure to halt or reverse this pattern will harm the livelihoods of South Africans for many years to come. The near-term risk then is for bond yields to rise and the currency to weaken. Over the longer term, however, the global search for yield is likely to force yields lower, aided by some potential help from the SARB's R500 billion QE programme. However, the country has lost its investment grade credit ratings, which exacerbates the problem by boosting borrowing costs at a time when debt repayments are already crowding out spending on development. In other words, debt-service costs outstrip spending on social and economic priorities. As such, borrowing more is not the solution, cutting more is not the solution. The solution lies in growing the economy, and ensuring that the growth agenda is focused on and enhanced.

Infrastructure

"Infrastructure will be the fly wheel by which we grow the economy. Just as we have tolled together to manage the pandemic, let us harness this same unity of purpose" - Minister Tito Mboweni

While Minister Mboweni painted a grim picture of the country's finances in his special adjustment budget, he said the government would be required to build high quality bridges, roads, railways, ports, and other infrastructure. President Ramaphosa recently hosted the Sustainable Infrastructure Development Symposium. Government has already committed circa R100 billion over 10 years towards the infrastructure fund. Minister Mboweni believes that 'together with the right projects, budget facility for infrastructure, sustainable finance, appropriate interest rate

policy, working with the private sector to green the economy'. The private sector accounts for most of the investment spending in the economy.

It therefore must be noted that South Africa has placed infrastructure at the centre of the stimulus our economy needs to achieve a sustainable recovery. In the long run, infrastructure investment increases the capacity of the economy, reducing the cost of transport and the capacity and reliability of key services like electricity and municipal services.

Number of Projects	Sector	Investment Value (R bn)	Job Creation
71	Housing	1 400	370 000
25	Energy	270	260 000
33	Agriculture	29	93 300
65	Transport	294	298 000
42	Water and Sanitation	170	96 000
7	Digital	108	707 000
243		**2 271**	**1 824 300**

At present, although there is much to be done on a fundamental level, we believe we are still some way from a sovereign debt crisis. The South African government does need to act now though, or it could lead us to getting there, sooner rather than later. We do believe that a focus on infrastructure and investment thereof, is positive and could bode well for economic recovery, if implemented successfully.

Positioning

We are bullish in nominal government bonds given current real yields of some 7.2%, well ahead of our revised fair value estimate of 5%. In the near term, the real yield on nominal bonds is expected to rise even further to around 6.5%, as inflation heads towards 3%. However, over the next 12 months we expect nominal bonds to deliver around 10-15% in absolute terms. We believe that sufficient risk has been priced into this asset class given the steepness of the yield curve, current real yields and the fiscal risks inherent in SA's recovery.

It is our belief that if an enabling environment is created such that successful implementation and execution of infrastructure projects are possible, it could well bode well for SA's economic recovery from the COVID pandemic. However, there remains a significant level of uncertainty around macroeconomic developments as the world emerges from one of the most significant impacts to economic activity during peacetime.

Sanlam Corporate Investments

July 2020

Sebinvestments@sanlam.co.za