Economic Overview for Business Owners

May 2017

The concerning message in sovereign debt rating downgrades

The response of financial asset prices to the Standard and Poor's (S&P) downgrade of South Africa's long-term foreign currency debt rating to sub-investment grade, has been relatively modest, since the event was largely "priced in" by market participants, while it also occurred against the background of renewed foreign investor interest in relatively higher yielding EM assets.

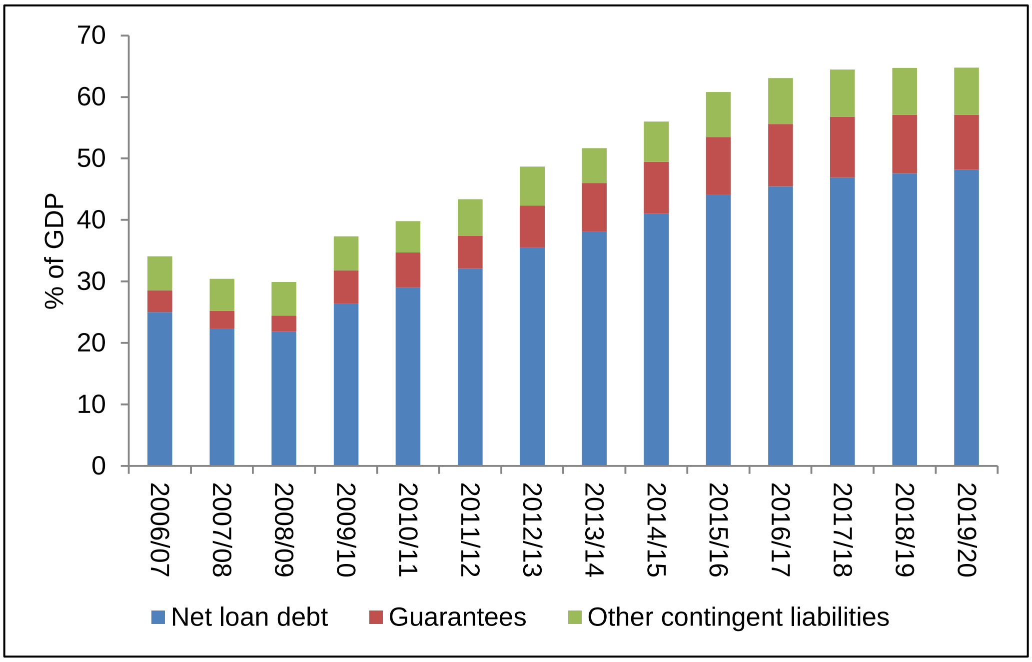
Why the downgrade? Amongst other factors, S&P noted the uncertainty around the future of politics and economic policy, as well as the increasing contingent liabilities at state-owned companies (SOCs).

The new Minister of Finance, Malusi Gigaba, has stressed the importance of good governance at SOCs and committed to implementing the existing Government Budget as read in February 2017. At the very least, in the near term close attention will be paid to any sign of deviation in policy from the fiscal consolidation path. The expenditure ceiling must be adhered too and there is no more room for a higher debt trajectory than currently planned. But in the long term, this may not be sufficient to avert additional downgrades, unless real GDP growth and per capita incomes lift meaningfully and sustainably.

I think it is reasonable to expect the National Treasury to stabilise the gross loan debt ratio at around 53% of GDP over the next two to three years, *provided* the economy delivers at least modest real GDP growth and the government primary budget balance improves to a surplus of +0.5% of GDP in two years' time (which requires adherence to the expenditure ceiling) as projected by the Treasury.

However, this would not guarantee long-term fiscal sustainability. At close to three per cent the current real interest rate on long-term government debt is too high. Given the current potential real GDP growth of just 1.5% this implies that the fiscal policy is unsustainable in the absence of a further sustained improvement in the primary budget surplus to around 1% of GDP (which would be difficult to achieve given the growing demands on expenditure against the backdrop of an excessively high unemployment rate).

Central government debt including contingent liabilities



Source: SA National Treasury, SA Reserve Bank

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Moreover, central government net worth has deteriorated markedly since the global financial crisis. Admittedly, net worth is difficult to measure – especially the asset component. But, assuming fixed capital stock is a reasonable proxy for assets, it can be shown that the central government's balance sheet has deteriorated through a combination of rising liabilities and a lower asset base. At least the net worth trend for the public sector, including both central government and state-owned companies (SOCs) has improved in recent years, mainly reflecting growth in the fixed capital stock of the SOCs. However, National Treasury calculations show a sharp deterioration in return on equity at SOCs in recent years.

Overall, South Africa's fiscal consolidation path has not been optimal. It seems the central government has not protected its balance sheet adequately and it has not cut consumption spending in favour of stronger capital expenditure. In this regard, next year's public sector wage negotiation is an additional risk. Also, the tax structure is not aligned with the GDP growth objective (since tax increases have focused on income and savings rather than consumption).

Meanwhile, central government contingent liabilities relating to guarantee exposure to SOC debt is expected to climb to R500 billion (10% of GDP in three years' time) from R308 billion at end March 2017. In addition, other contingent liabilities, including the Road Accident Fund and claims against government departments amounted to R330 billion (7.6% of current GDP) at end March 2017.

It is against this unfavourable backdrop that S&P has maintained a negative outlook on its rating. Considering all of this it is not surprising the bond market has already shifted towards pricing in a further downgrade in our foreign currency debt to around BB from BB+.

In the absence of decisive policy action, tailored to arrest these unfavourable fiscal trends the risk is additional downgrades. The accompanying impact on the Rand, inflation and long-term interest rates would depend on the monetary and fiscal policy responses , as well as global financial conditions.

Finally, note that the risk currently should not be a default on government debt, but rather higher inflation, since90% of government debt is denominated in Rand and the government can print money. Sound fiscal trends are important in the long run if a low inflation objective is to be met. Hence, the increase we have seen in real South African interest rates as lenders raise the inflation risk premium priced into bonds.

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