Is South Africa approaching an IMF bailout?

David Knee
CHIEF INVESTMENT OFFICER

KEY TAKE-AWAYS

- There is no widely accepted "magic number" for debt levels at which a country needs to be bailed out.
- While SA's government debt/GDP ratio is high, our foreign currency debt is low. It is the ability to repay this debt that primarily determines whether a bailout is necessary.
- SA is able to repay its bonds, and has few of the other symptoms that accompany a debt crisis, such as very high inflation and a rapidly depreciating currency.

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In the wake of the gloomy numbers contained in Finance Minister Tito Mboweni's Medium-Term Budget Policy Statement (MTBPS), there is increasing concern among investors that South Africa will have to turn to the International Monetary Fund (IMF) for a bailout to fund the country's growing debt levels.

In the MTBPS, the government budget deficit showed a worrying increase to -5.9% of GDP from -4.5% for the current financial year, peaking at -6.5% next year and returning to -5.9% in 2022/23. At the same time, the total debt burden was adjusted higher at 61% of GDP from 57% in the current year, and rising to 71% by

2022/23 in the absence of any further measures to constrain expenditure or raise revenue. Investors and the global credit rating agencies were disappointed by Mboweni's failure to show a clear path toward reducing debt levels over the next three years in the face of still-sluggish GDP growth and high spending requirements. It also increased the likelihood of further credit rating downgrades to come, a fact subsequently confirmed in the responses of Moody's and S&P, where they noted the deterioration and potential for further downgrades if no action is taken.

In reaction, both the rand and local bonds sold off to reflect these concerns. But despite it all, are we really approaching a fiscal cliff and the need for an IMF bailout? Is there a debt level at which countries are "automatically" considered to have reached a debt crisis?

"SA's domestic bond market has the second-longest maturity profile in the world."

High debt levels – an international perspective

It turns out that there is no agreed "magic number" for a country's debt/GDP level at which it becomes "too high" and will negatively impact the economic growth rate, or will require an IMF bailout. All countries have a unique story. However, there are indicative academic studies that can provide direction for South Africa. Some of those undertaken after the GFC focusing on the impact of gross debt levels on economic growth have found that there has been a weak relationship between the two. They did find, however, that once a nation's debt/GDP ratio passes 90%, the impact on economic activity from the government taking on additional debt is negative. This is corroborated by research by the European Central Bank (ECB) and the Bank for International Settlements (BIS).

If we look at Argentina, which received its most recent IMF bailout just over a year ago, the country's debt/GDP ratio had risen to 60%, but importantly, a high proportion of this was held offshore. Also, inflation had risen to 50% and the peso had depreciated significantly. Consequently, the government had difficulty repaying

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its hard-currency debts and the IMF had to step in to help. Many IMF bailouts in the past have occurred under similar conditions, such as Russia in 1997 and Ghana in 2015. The issue is not necessarily a country's total indebtedness, but the extent to which it has borrowed in foreign currency. The government cannot print US dollars, euros or yen, and if its economy deteriorates, it can't borrow the currency to repay its existing debt, and a crisis develops.

So how does South Africa compare? While our current debt/GDP level, at around 60%, is in line with the levels of Argentina, Russia and Ghana before their IMF interventions, only around 10% of government debt is denominated in foreign currencies, and this debt has an average weighted maturity of 10 years. Additionally, our inflation rate is contained at around 4%. A further differentiator is the structure of our government bond market, where unlike many other emerging markets, bonds are issued at maturities out to 30 years, making refinancing risk very limited. In fact, South Africa's domestic bond market has the second-longest maturity profile in the world (after the UK), creating a structural strength in our financial market that sets us apart from many other emerging markets.

That is not to say that we shouldn't be alarmed by the current debt trajectory on which the South African government finds itself. It is a serious situation, particularly as we are being forced to spend more and more of the government's scarce budget on higher interest repayments. This is why it's vital that the government develop specific plans to control expenditure, reform indebted state-owned enterprises, enhance economic growth and limit any further expansion of the borrowing requirements. Measures to achieve these aims will hopefully form part of the February 2020 budget - the market and rating agencies are now looking to this for signs that a serious reform agenda is underway. ■

David joined Prudential in 2008 as Head of Fixed Income and was appointed as Chief Investment Officer in 2016. With 29 years of industry experience, David has worked in a range of senior roles within the fixed income space, both in South Africa and abroad. He holds a Bachelor of Science degree in Economics from the London School of Economics, a Bachelor of Science (Masters) degree in Economics from Birkbeck College and is an Associate of the Society of Investment Professionals.

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