PRUDENTIAL **INSIGHTS**

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With action, South African debt crisis is avoidable

There's no question that South African investors are facing an increasing risk that the South African government might, at some point, be unable to repay its debt, and therefore spark a sovereign debt crisis. This is if nothing is done in terms of narrowing the government budget deficit and implementing more structural reforms to spur economic growth. In the past few years we have seen the absolute level of government debt growing and debt as a percentage of GDP rising, as well as the costs of servicing that debt surging.

South Africa facing high debt levels

History has shown that investors will tolerate high government debt levels of well over 100% of GDP in developed countries like Japan, Greece, or Italy without sparking a debt crisis, but in emerging markets like South Africa research has found that this threshold is lower, at around 80% or so (or even lower in the case of countries with high debt service costs). This is the debt/GDP level where we in South Africa found ourselves in the 2020/21 financial year, and National Treasury's projections show it rising to reach 88% by the 2025/26 financial year. This upward trajectory has been caused by the increased costs associated with the Covid-19 pandemic and rising government budget spending in recent years, combined with disappointingly low growth since 2015.

The government is now spending far too much on wages and debt servicing costs as a percentage of its revenue, leaving it significantly less for funding more productive investments like infrastructure, healthcare and education improvements that will boost economic growth. We are at the point where debt is "crowding out" investment and impacting negatively on our growth rate.

If we are unable to implement budget spending cuts, as well as successful structural reforms, and attract investments that increase the economy's capacity for growth, South Africa could face a vicious circle of rising debt and deteriorating growth that results in a debt crisis. But is this scenario inevitable?

Government trying to cut debt, implement reforms

The government is making efforts to reduce its debt levels through negotiating public sector wage cuts and planning for lower spending in its Medium-Term Budget plan. It is embarking on important structural reforms, among them including: liberalising the energy sector by allowing companies to generate electricity from multiple sources (so-called embedded generation); reducing the red tape facing new companies by cutting the time required to approve a start-up business to only 48 hours; and securing much-needed domestic and foreign investment totaling around R780bn through its series of investment summits. One example of this has been the new Amazon data centre set up in Cape Town, and many others are planned. Although these investments will take time to be realised, they will create even more business opportunities and new jobs that will spur economic growth.

On another positive note, South Africa's external finances, a key element of our sovereign credit rating, have performed well during the pandemic, with strong commodity prices helping the country achieve a current-account surplus of 2.2% of GDP, the first surplus since 2002.

No better time to buy SA assets

At Prudential, our view is that a debt crisis is avoidable with the right government actions. All of these efforts now underway should help South Africa avert a sovereign debt crisis. In fact, there has been no better time to buy South African assets than the present due to the extreme pessimism weighing on local markets. The current very high yields on government bonds are compensating investors well for the risk involved in owning them; for example, 20-year bonds offer equity-like returns. As an asset class SA bonds have the potential to deliver a real return of 4.6% (at the time of writing) over the next three to five years. At the same time, South African equity valuations are also very attractive relative to their own history and versus offshore equities, offering a potential real return of 10.1% over the medium term, based on our calculations. By constructing well-diversified portfolios including both local asset classes as well as global assets, we believe investors should be well-positioned to achieve higher-than-average returns in the next three to five years.

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