SA’s great unravelling: can the economy still be saved?

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SA’s great unravelling: can the economy still be saved? SA has arrived at a point where politics and debt collide. Though the country seems locked into terminal decline, there is an outside chance that the Ramaphosa government can arrest its deep dive before it drowns BL PREMIUM 15 August 2019 - 05:00 Claire Bisseker SA is sliding inexorably into a debt trap, with the government unable to make the hard political choices necessary to spark growth, or to prevent a steady rise in the country’s debt ratio. Though finance minister Tito Mboweni has warned that "we really and truly cannot go on like this", there is every indication that this is exactly what will happen. If its current trajectory continues, the government will keep using taxpayer and pensioner funds to prop up failing state-owned enterprises (SOEs), and run down the country’s asset base rather than cull the bloated public sector. It’ll leave SA looking like just another undeveloped country. The good news is that SA has some attributes, or buffers, which mean it could take years before it hits rock bottom. The bad news is that the longer this downhill slide continues, the more damage will be done and the harder it will be to climb back up. "We should be worried," says Michael Sachs, former head of the National Treasury’s budget office. "The state is rudderless and taking on water, but I don’t think it’s about to sink." Rather, Sachs thinks SA is descending into a structurally weaker equilibrium — a "new normal" where it will languish for the next five to 10 years. It will edge ever closer to, but somehow avoid, outright disaster. Cyril Ramaphosa. Picture: FINANCIAL MAIL The feeling of economic despair in the streets is tangible right now. But, as Harvard economist Ricardo Hausmann says about his home country, Venezuela, we could find ourselves looking back after 10 years and saying: "Remember when we didn’t know how happy we were?" In other words, while we think things are bad now, they could get much worse — if the current trends of low growth, rising unemployment and mounting debt continue to be met with catatonic policy uncertainty, confusion and half-measures. This grim prognosis is increasingly shared by economists, given the government’s failure to implement decisive economic reforms. Nowhere is this more evident than in the glacial pace of the restructuring of Eskom and SAA. The CEOs of both utilities have resigned in recent months, leaving funders tearing their hair out in frustration. SA is in a "profound and deepening economic crisis", concludes a fiscal report by the Centre for Development & Enterprise (CDE), due to be released this month. It is titled, aptly, "Running out of road". "SA’s public finances are increasingly precarious, its macroeconomic fundamentals are increasingly unsound and the path we are on is increasingly unsustainable," the report says. "It is hard to avoid despair about whether government and the ruling party fully grasp the depth of the changes required and how much leadership it will take from the president to get this done." Last week, after meeting President Cyril Ramaphosa, Business Unity SA (Busa) president Sipho Pityana released a hard-hitting statement, blaming SA’s economic and fiscal deterioration on the government’s reluctance to take the decisions required to stabilise public finances and create conditions more conducive to economic growth. "We made it clear, for example, that we do not believe the government is being realistic in dealing with debt and we are moving closer and closer to a debt trap," said Pityana, "The truth is that aggressive fiscal consolidation is needed, particularly when it comes to SOEs … It needs to … come to terms with the fact that it probably won’t be able to save all of them." Click to enlarge. Unless the government adopts fiscal austerity of its own accord, SA will head towards the International Monetary Fund (IMF), which would force it to do so, Pityana warned. "We told our social partners, it’s crunch time." The idea that SA is on a fast track to the IMF is gaining currency — but several economists dispute this. Like Sachs, they point out that the SA economy boasts several mitigating factors, some rare in an emerging market, which should enable the government to keep kicking the can down the road. Here’s one such factor: an estimated 55% of developed-economy government bonds currently offer investors a negative yield, but SA offers a real yield on 10-year government bonds of about 4%. This makes it, theoretically, an attractive investment destination. And this should keep capital flowing in, and supporting the rand. Also, SA has a floating exchange rate, and its government debt has a long-maturity structure and is almost all issued in rands. There's another cushion insulating the government from having to take tough steps to reduce debt: the public sector has a relatively high net worth, equal to 151% of GDP, according to the IMF's 2018 fiscal monitor. That makes SA the sixth-best performer out of 31 countries, including a number of developed nations. Which means there is some space for the government to cut capital expenditure and keep squeezing its assets, as it has been doing for the past 10 years. Of course, there are obvious dangers to that approach – the reports that 78% of Gauteng's bridges are in a poor state due to a lack of maintenance is just one such potential pitfall. SA also has a much bigger domestic investor base than many peer countries, including a large banking sector and a deep pool of institutional investors. In fact, SA's insurance company and pension fund assets, combined, exceed 160% of GDP. Click to enlarge. Also virtually unprecedented among emerging markets is that the state pension scheme, the Government Employees Pension Fund (GEPF), is fully funded. According to a recent actuarial evaluation, the GEPF holds R1.8-trillion in assets — sufficient to cover 108.3% of its liabilities on a best-estimate basis (which measures the present value of future liabilities). (On a stricter liability measure, taking into account the reserves the fund has to hold to make pension payments and remain solvent, its assets cover 75.5% of its liabilities.) The point is, the GEPF owns about 40% of the combined assets of all SA's pension funds, which stand at about R4.2-trillion. This means that not only does it hold a large share of all the savings in the economy, it also funds a large portion of the fiscal deficit and of SOE debt, including almost R55bn worth of Eskom bonds or 16.8% of its outstanding debt. This is more than five times the amount held by the next biggest holder. Sachs fears that given this vast resource pool, the question is not whether SA will end up at the IMF, but whether it will be more painful to go to the IMF or the GEPF for a bailout. "I imagine it would be less painful to go to the GEPF and make some deal with the unions not to protest against it. In short, to use the pension system to shift problems into the future," says Sachs. He envisages public sector workers agreeing to, say, an increase in their pensions in exchange for allowing the government to erode the fund's capital base in the short term. There is an argument that, since the GEPF is a defined benefit fund (where pensioners get a set monthly payment, irrespective of investment returns), all its liabilities fall on the state's balance sheet anyway, so its assets should also be seen as an extension of the state and be available to fund development. This is strongly rejected by the Association for Monitoring & Advocacy of Government Pensions (AmaGP), an NGO committed to ensuring the GEPF's long-term sustainability. AmaGP spokesperson Adamus Stemmet says the legislation is clear: the object of the fund is only to provide pensions and related benefits to its members, but this prescription seems to have been ignored by the fund's board and trustees. Sipho Pityana. Picture: DOROTHY KGOSI Stemmet fears that the legislation doesn't provide the fund with sufficient protection in the current economic climate — "because if it did, we wouldn't have seen the current misuse of it for, among other things, bailouts of bankrupt, badly managed SOEs and other struggling ventures". It's a good point. If your primary goal is to look after pensioners, how could the GEPF justify investing in risky assets like Eskom? Certainly, the 240,000-strong Public Servants' Association (PSA) feels this way. "The PIC needs to get out of Eskom," PSA deputy general manager Tahir Maepa said in a recent interview with Bloomberg. "So long as they have the PIC as a piggy bank, they will never be able to sustain themselves and run like a business." Though AmaGP doesn't believe the unions and employee organisations will act against the GEPF's interests, it is prepared to go to court to defend the fund's long-term sustainability if necessary. The government might find it hard to win such a battle, given the arguments about fiduciary duty. The fact that the PIC has a new board under former Nedbank chair Reuel Khoza, which includes three union members and former Absa CEO Maria Ramos, could also serve as a brake on the state's worst intentions. Interestingly, Sachs doesn't expect the government to try to force prescribed asset requirements onto the private sector, as this would probably ignite a battle royal. Under a prescribed assets regime, private sector pension funds would be forced to invest in some government-approved assets (like Eskom.) The financial sector thinks it unlikely that such a policy will ever see the light of day under this government, since it would do too much harm to ordinary savers. This, after all, is what happened when there was a prescribed asset requirements policy during the apartheid years. During the 1970s, pension funds were forced to invest at least 53% of their portfolios in government and SOE bonds. Over the decade, they delivered a negative real return of 4% a year, versus a positive 13.2% real return by equities, says Gill Raine, a senior policy adviser at the Association for Savings & Investment SA (Asisa). It seems impossible to square this forced underperformance with the fiduciary responsibility placed on pension fund trustees to manage a fund responsibly. Raine says that implementing prescribed assets would also force institutional investors, such as Allan Gray and Coronation, to shift their current asset allocation — which would cause a huge wealth ripple across SA. Michael Sachs. Picture: Sowetan For instance, she calculates that even if these investors were to move just 10% out of equities, assets of roughly R1.1-trillion (more than 7% of the JSE) would have to be sold. This would hurt stock prices and destroy investor wealth. It would be chaotic. Yet, despite the evidence of how destructive a prescribed asset policy could be, the ANC still views SA's national savings pool as a potential "resource" that could be used to avoid the IMF (see box on page 24). Says Pityana: "One of our biggest fears is that there may be increasing coercion of financial institutions to extend credit to SOEs that are already up to their necks in debt. That will present a systemic risk to our … financial services sector and compromise one of the few remaining pillars of our economic system that makes SA an attractive investment destination." Intellidex's Peter Attard Montalto thinks that even if a prescribed assets policy is not enforced, local banks and asset managers will continue to bail out the government for a range of reasons. "First, there is often the direct political pressure being applied by the president and senior ministers. Second, there is peer pressure and third, there is a fear of the alternatives," he says. "When you have such a large exposure and such a messy political economy, when the government says jump, during a restructuring, you will say: how high?" Rather than, for example, demanding cutbacks, or going to court to enforce guarantees. But by not enforcing these rights, the private sector would be failing to discipline government behaviour. Futuregrowth chief investment officer Andrew Canter, who suspended lending to six SOEs in September 2016 on governance concerns, says he's not aware of any direct attempts to coerce institutional investors to invest in government debt. However, Canter reveals that there was "a big push" about six months ago to persuade institutional investors to invest in a "special purpose vehicle" designed to lend to some of the smaller SOEs — including SAA, the SABC, SA Express and Denel. Though the fund would have had a government guarantee, Canter dismissed it as a "terrible idea". After all, none of the SOEs was a sustainable business and there was no clear conditionality attached to the loans to ensure they became so. As far as he is aware, other funders also balked at the idea. Futuregrowth holds R5bn in Eskom debt but has not lent it any more since pulling the plug in 2016, in line with its view to invest only in sustainable entities. "Like all South Africans, we're waiting for the hard decisions to be taken," says Canter. These include decisions around Eskom's staffing efficiency, its unbundling into three units, its balance sheet restructuring, and how the energy sector will be reformed. But Canter says the real concern is the political intervention and lobbying by people who want to protect coal interests and who want to protect jobs. There's a palpable lack of certainty. "The markets don't know if this administration has the authority from the party to do what needs to be done to sort this out in a sustainable way," he says. The upshot of the government's inability to make decisions is that SOEs are left in limbo. Like the SA National Roads Agency Ltd, since e-tolls have effectively been scrapped. Or the SABC, since retrenchments were frozen. This erodes their institutional capacity, causes an exodus of competent managers, burdens the fiscus and ultimately harms economic growth. Trudi Makhaya Sachs says SA's fiscal policy has been neutered by the government's failure to force departments and SOEs to remain within their budgets. The result: nearly every department is, like Eskom, "in a death spiral". It has become common for government departments to have run through their budgets by November, he explains. They then run up debt to their suppliers which they promise to pay back the next April, out of their new budget allocation. Only by then, their budget runs out by the following October .... it's a downward spiral. In this way, the health department has run up a hidden deficit of R25bn, mainly on medicines. SA has got itself into this mess through years of overspending on a burgeoning and unproductive government in an environment where growth has underperformed every year since 2011. The debt ratio has doubled in the past 10 years and is set to hit 60% of GDP following Eskom's latest bailout. The hardest question of all is where the government is going to draw a line on the debt ratio. Will it be at 70% — the IMF's high-risk threshold? Or it is prepared to sell state assets and cut public wages and jobs to curb borrowing, before it's too late? The problem with having let matters build to such a head is that the degree of fiscal austerity (tax hikes and budget cuts) required to stabilise the debt ratio at 60% this year will be about R125bn — so huge that it could put the economy into reverse. But even if the adjustment is spread out over five years, it's going to be extremely difficult for the government to raise taxes and cut expenditure substantially (if it avoids the holy cows of a VAT hike and public sector wages cuts) because of the fragility of growth and the extent of fiscal consolidation already undertaken. Trudi Makhaya, Ramaphosa's economics adviser, says SA has little to show for the surge in public spending over the past decade. And this is largely because that spending was skewed towards consumption — not investment. "This will be reversed in coming years, with consolidation directed towards curbing government consumption spending, but increasing the bias towards infrastructure," she says. "Fiscal measures to reduce spending are unavoidable, but they have to be done in a thoughtful manner that does support long-term growth." But you can't really underestimate just how tough this will be. Since 2014, SA has cut R70bn from noninterest expenditure (NIE) and for the past few years spending has fallen on a per capita basis, even though it has remained ahead of inflation. Sachs expects the Treasury to keep cutting costs along the path of least resistance: the soft options are public infrastructure (courts, hospitals, police stations), research and innovation, and housing. The problem is, this will further erode the state's net worth, stacking up bigger problems for later. The civil service, which swallows 39% of the country's noninterest spending, is the obvious place to cut. With roughly 2.7-million people, it is one of the best compensated (relative to GDP) in the world. But it also happens to be one of the most inefficient. However, here's where the politics matters. There is little political space for Ramaphosa to consider mass retrenchments, let alone cuts to social services, in a country where 29% are unemployed and 55% live in poverty. And, anyway, he has said that retrenchments are not on the cards — a promise he will find hard to reverse. Click to enlarge. Nor is there much space left in which to raise taxes, without dampening growth further. After years of increases, personal income tax accounts for 38% of gross tax revenue — that's a 20-year high. In fact, the biggest bullet in the tax arsenal is a VAT hike. But a one percentage point hike in VAT delivers only about R22bn in extra revenue, which doesn't really touch sides. Mboweni needs R128bn over the next three years just for Eskom. Anyway, given the public backlash, further VAT hikes must be off the table. Privately, Treasury officials tell the FM they are "very worried". These officials continue to be amazed when politicians talk about raising VAT or payroll taxes to fund National Health Insurance (NHI). What the politicians still don't seem to grasp is that there is no fiscal room — not for NHI or, in fact, anything else. "We cannot afford what we already do. There is no room to increase the list whether for new, smart cities, NHI or substantial numbers of additional police officers," says the CDE report. "Our situation requires a tough choice of priorities for expenditure and ferocious determination to stick to these." And it also means SA must implement reforms to raise the growth rate. As the CDE points out, not only have the serial GDP growth disappointments contributed to the build-up of public debt, but the high debt has caused growth to slow further by raising the cost of capital and increasing risk. The bottom line is that SA is on the horns of a dilemma: unless it deals with its fiscal crisis, growth will not accelerate. But the opposite is also true: unless SA gets growth going, it will not get on top of its fiscal crisis. In fact, 2019 has become the year that economists have long warned about — the year when SOE debt lands up in the government's lap, when tax hikes no longer really work, and harsh austerity measures are required to return SA to fiscal sustainability even though in the short term these measures will depress the growth on which tax collection depends. "Everyone agrees we're on a fiscally unsustainable path and the order of the problem requires drastic steps," says Rand Merchant Bank chief economist Ettienne le Roux. "If we carry on, it's quite obvious that we will end up at the IMF." But he points out that the ANC faced a similar conundrum in 1994 — a need to increase social expenditure while having to contain apartheid debt. As weak growth precluded raising tax rates, the onus fell on expenditure cuts, especially to the wage bill, to reduce the budget deficit. Through a range of policies from wage restraint to headcount cuts, the government slashed the wage bill from around 36% of its noninterest spending in the late 1990s, to about 28% a few years later. "The government took action, which meant fewer teachers, police and nurses," adds Sachs. "I'm not sure if it was the right choice then or if it would be the right choice now, but the difference is that a choice was made. Now no choice is being made, it's utterly rudderless." Click to enlarge. Le Roux says Mboweni's policy actions don't have to be as extreme, if he combines efforts to moderate the wage bill with the sale and restructuring of state assets. Under former finance minister Trevor Manuel, privatisation netted R54bn between 1993 and 2008 — money used to cut debt and lower the interest burden. Researchers estimate that SA's debt ratio would have been 34.2% instead of 28.3% by 2008, had privatisation not been implemented. But, of course, the problem isn't that SA doesn't know what to do to solve its fiscal challenges. The problem is that the ANC is too weak politically to be able to do what Manuel did then, without tearing itself apart. "The big problem isn't really a fiscal one," agrees Sachs. "It is much deeper than that. Ramaphosa has stemmed the decay but he's been left with a state and party that is incapable of making choices, because to choose is to disappoint some people." Even when choices are made, it seems the state lacks the capacity to turn those choices into effective policy because of the lack of professionalism in the public service. "I think we all underestimated the degree of decay that beset key institutions in the past," says Makhaya. She says Ramaphosa has placed a "laser focus on execution and co-ordination" and that it is clear that the government "needs to move with ruthless urgency to remove barriers to economic activity". Last week, the president exhorted directors-general to speed up measures to turn the economy around — like launching the new infrastructure fund and removing visa obstacles. Makhaya says that at the heart of SA's economic malaise is declining productivity. It's partly a result of low fixed investment, weak human capital development and inefficient network industries (like power and logistics). "Any efforts to stimulate the economy superficially, without getting to the heart of the productivity challenge, will only yield limited results," she warns. "Stimulating demand is important, but structural improvements to how the economy functions are even more important. Government is very alive to that, and measures such as the new approach to infrastructure delivery, and identifying productive sectors for social partners to rally around, can stem economic decline." Makhaya says many of the measures in Ramaphosa's stimulus package are coming into effect, which will spur economic activity and improve policy certainty. The public-private growth initiative "could unlock significant flows of investment", she adds. At least R250bn out of R300bn in investment pledges made last year have progressed to the implementation stage, Makhaya says. Seven companies have undertaken capex projects as promised, Makhaya confidently suggests there is hope that Ramaphosa is alive to the challenges, and won't allow SA to drift along its current path indefinitely. Which is just as well: there are considerable risks to muddling along as we have these past 18 months. What it means What it means: Despair is mounting over SA’s challenges — though the country isn’t about to need an IMF bailout, it could keep sliding downhill for years Sanlam Investment Group economist Arthur Kamp identifies two such risks. The first is the risk of bond investors becoming disillusioned. Though it’s clear SA’s debt trajectory is unsustainable, and while real yields on government debt have increased steadily as SA’s debt rating has deteriorated, Kamp says the bond market hasn’t revolted. The effective real interest rate on government debt is still relatively low. "This suggests that investors think there are levers the government can and will pull to steady the ship," he says. "The moment the market doesn’t believe this is possible or likely any more, real bond yields are likely to spike. This is the point, if reached, where it’s clear the government can no longer change the upward trajectory in the debt ratio — that it’s in a debt trap." The second risk is that the longer SA drifts in the wrong direction, the greater the likely build-up of pressure to adopt populist policies. You know the drill: print more money, institute prescribed assets and interfere with the Reserve Bank’s independence. "At best this would only delay the inevitable," says Kamp. "More likely, it would spook investors." But while the bond market may say that SA is not about to go over the fiscal cliff, or to the IMF any time soon, the country is experiencing a slow, relentless unravelling. And though there is still hope that Ramaphosa can wrest back control over the fiscus and find renewed vigour, if he doesn’t do it now, the outcome will be sadly inevitable.