BRENTHURST
THE HOME OF WEALTH

THE POWER
OF INDEPENDENT ADVICE

www.bwm.co.za

SA'S LOOMING ECONOMIC CATASTROPHE

– DEBT CRISIS THREATENS STABILITY

By Magnus Heystek | Director and Investment Strategist, Brenthurst Wealth

For many years, energy experts tried to warn the ANC government that it was heading towards an energy crisis, mainly thanks to the under-investment in new generating power stations, as well as lack of maintenance, fraud, corruption and just plain theft at ESKOM. However, government did not listen.

Consequently, load shedding is now the order of the day with power interruptions for up to six hours a day, costing industry and consumers billions of rands and resulting in a massive drag on our GDP growth.

One can almost allude to the same with the collapse of Transnet, our roads and municipal infrastructure. Government has been warned, time and time again, that SA is heading towards an economic disaster and that urgent intervention is needed. There is very little evidence that the government is taking any notice.

Another crisis has been brewing under the surface for an equally long time: SA's debt crisis has slowly, but inexorably, been rising from a paltry debt of R500bn in 2006 to a mind-boggling R5 trillion today. Government's finances are in a shambles and it is borrowing billions of rands every month just to repay previous loans and the interest thereon.

By itself, this does not mean much. But it will when the forecast economic growth — and the concomitant tax revenues that goes along with that — collapses as a result of over-reliance on the commodity cycle and a surprising economic slowdown in China, SA's largest trading partner.

IN THIS ISSUE

"Investors urgently need to increase the dollar-based investments in their portfolios. This can be done via asset swaps (the easiest), the R1m single discretionary allowance (SDA) and the R10m offshore investment allowance. In a full-blown debt crisis these dollar-based investments will be invaluable."

JHB (HQ)	+27 (0) 11 799 8100
JHB (SANDTON)	+27 (0) 10 035 1391
PTA	+27 (0) 12 347 8240
CAPE TOWN	+27 (0) 21 418 1236
BELLVILLE	+27 (0) 21 914 9646
CLAREMONT	+27 (0) 21 100 3901
STELLENBOSCH	+27 (0) 21 882 8706
PAARL (VAL DE VIE)	+27 (0) 21 100 3901
GEORGE	+27 (0) 82 551 3299
MAURITIUS	+ 230 5843 5215

SA's economy is sensitive to changes in commodity demand, especially iron ore, manganese, diamonds and gold. It benefitted massively from commodity windfalls in 2004 to 2008 and also in 2021 and 2022. But this year demand from China has decreased dramatically, impacting SA export, company profits and, hence, taxable earnings. Government has, again — like previously — relied too heavily on an extended commodity cycle. Windfall profits were seen as permanent.

WARNINGS GALORE

For many years certain economists and interested parties have tried to warn government that it is on an unsustainable path, such as Dawie Roodt from the Efficient Group, as well as Prof. Jannie Rossouw and his colleagues at the Fiscal Cliff Study Group (FCSG). They have now been joined by Afriforum and Sakeliga, with both organisations now becoming bolder in their warnings about SA's trajectory towards a debt crisis and, soon thereafter, a failed state.

Two Sundays ago the Sunday Times woke early rising South Africans from their peaceful dreams with a "SA IS BROKE" headline on the front page.

A week later, this was followed by another front page scoop about the (apparently urgent) meeting of the cabinet and members of Treasury at the Spier Wine Estate, to discuss the potential fall-out from a fiscus rapidly running out of money. What makes it even worse, is that this is happening shortly ahead of a general election in 2024, a time when government-in-power loves to open the spending tap.

This time around, there simply is no money, even though the ANC-led government still keeps on talking about a Basic Income Grant as well as the introduction of the National Health Insurance (NHI). Quite simply, there is no money for this, but such a triviality has never stopped the ANC from making extravagant promises – think bullet trains and smart cities, etc.

Therefore, in my view, it is time that investors start taking note of what is happening with SA's spiralling debt crisis. If left unchecked or ignored by government, we could move towards a full-blown debt crisis within the next 3-5 years, with devastating consequences for economic growth, interest rates and, subsequently, inflation and the exchange rate.

SLEEPWALKING TOWARDS A FISCAL CLIFF

WILL THE GOVERNMENT LISTEN THIS TIME AROUND?

FISCAL CLIFF OR FISCAL SWAMP?

"It's still too early to be talking about a debt crisis, or fiscal cliff as it has become known in general terms. But if current trends are not reversed, such a scenario WILL happen," says Prof. Jannie Rossouw from the Fiscal Cliff Study Group. (He is also connected to the Wits Business School.)

"It's a pity we called it a fiscal cliff, as it rather becomes a fiscal swamp with government lending money to repay interest on previous loans, wages and salaries, with no money left to spend on infrastructure. The end result is a default on foreign debt and an application to the International Monetary Fund (IMF) for further loans to come to government's rescue," he said by phone from London, where he was attending a conference.

The IMF was in town the other day – in Cape Town. Gita Gopinath, 2nd in command and formerly its chief economist, warned openly that that the interest owed on SA government debt could increase exponentially, placing the country in a debt spiral. The IMF projects that the interest bill on government debt could spiral to triple the size of its health budget within 5 years. This would result in interest payment on debt consuming 27% of the country's entire budget, up from the current 19%.

She said the government must take a two-pronged approach to reducing its deficit: cutting government spending and implementing structural reforms. The IMF further added that it doesn't see improved economic growth coming to the rescue. Growth this year will be 0.3% and only 1.4 % per annum in the medium term.

CURRENCY COLLAPSE IN THE CARDS

International experience shows that countries who do enter into a full-blown debt crisis lose 75% of their currency value in the first year after such an event and then, on average, another 25% in the following year. Two weeks ago, National Treasury revealed that SA recorded its largest budget deficit since around 2004, sending the rand crashing and lowering the demand for government bonds. In July the budget deficit was R143.8 billion compared to a surplus of R36.7 billion the previous month.

National Treasury is reportedly proposing a host of extreme measures to get national departments and other spheres of government to cut spending, as the country's coffers have run dry. Treasury's **data this week** showed that the budget moved to a deficit of R143.8 billion for July, the largest since 2004 and wider than the R115.5 billion forecast by economists.

Economists are also **sounding the alarm on the full-year outlook**, with South Africa's fiscal deficit for this year expected to exceed the budget set by Finance Minister Enoch Godongwana by some margin. South Africa's fiscal deficit for 2023 is set to be between 6% and 6.5% of gross domestic product (GDP) – much higher than the minister's expected 4%. In the budget speech, Finance Minister Enoch Godongwana said the government wants to stabilise South Africa's debt level at 70% of GDP, but it has already increased to 72%. As a result, South Africa's debt situation has also worsened significantly, moving from a relatively modest R500 billion in 2006 to over R4.7 trillion in 2022. This is expected to hit R6 trillion by 2025, putting the country in a significant debt trap.

Similar warnings have emanated from the South African Reserve Bank, which raised red flags over the country's debt situation. Godongwana is acutely aware of the fiscal problems the country faces and, in a draft document recommending solutions, proposes huge cuts to spending, a moratorium on advertising new hires and forcing departments to find other means to fund wage increases.

The austerity measures would mark the first time since 2013 that the National Treasury takes an official stance, and it is particularly notable as this would come ahead of a national election. The document reportedly points to much lower-than-expected tax revenues as well, which exacerbates the funding crunch. It was also reportedly recommended that the provinces introduce similar measures.

South Africa's provincial governments and municipalities are in deep financial crises, with major metros already having run out of money and many others nearing collapse. The City of Tshwane has run head-on into a battle with its municipal workers over wages, with the threat of being placed into administration now looming over its head.

Other metros, such as the City of Jo'burg and the City of Ekurhuleni, are struggling to replace parts and do repairs to city infrastructure, with the latter announcing this week that it would have to stop the repair of traffic lights and instead replace them with stop signs, as funds for repairs have been depleted.

Municipalities' financial stresses are well known, with one of the most obvious markers being how indebted they are to power utility Eskom, where money owed has rocketed to R64 billion.

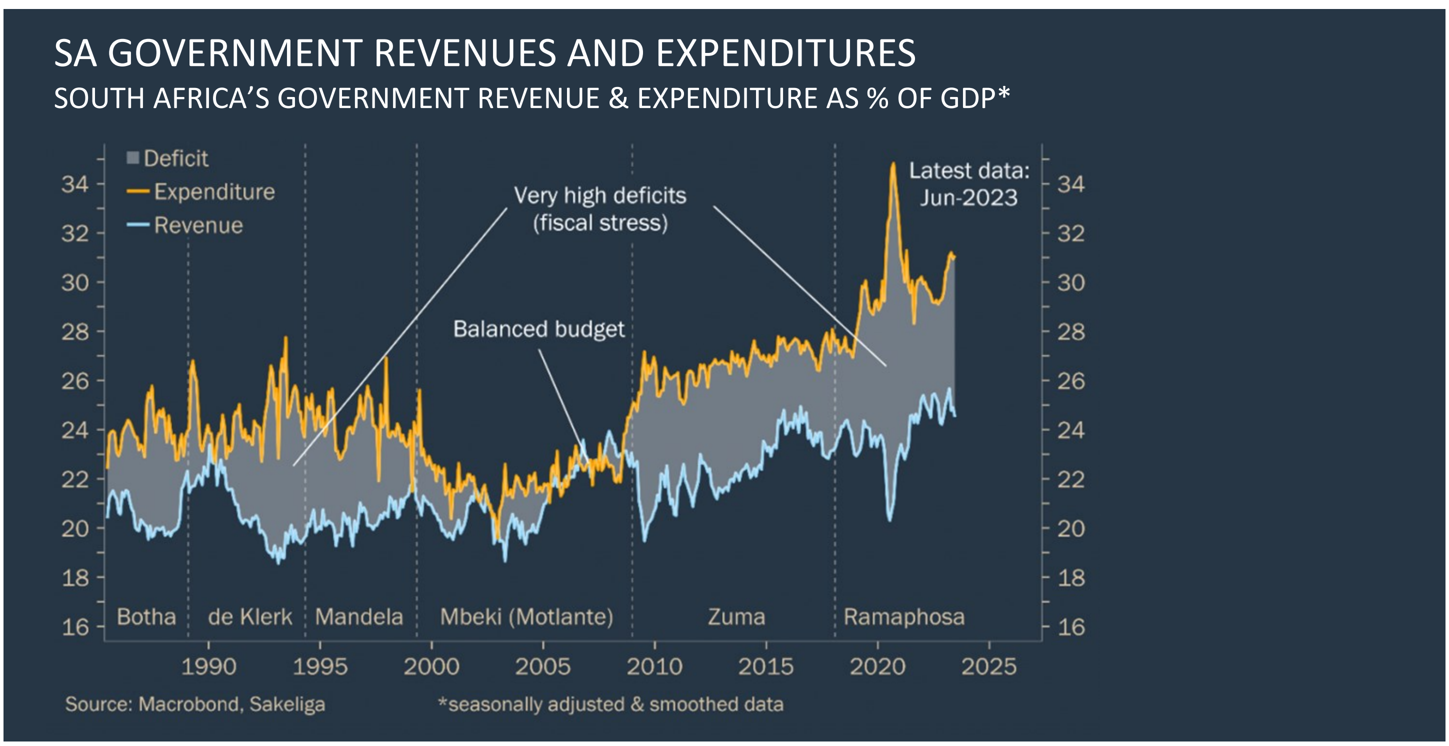
FAILED STATE WARNING FOR SOUTH AFRICA

Business interest group, Sakeliga, says South Africa's latest round of data shows that the country is in deep financial distress – a situation that is almost always followed by state failure, BusinessTech wrote last week. Government finances have deteriorated sharply in 2023, as tax receipts have fallen further behind the pace of spending.

"Government borrowing has now swelled to around R100 billion per quarter, from an already-imprudent R50 billion per quarter just a year ago," the group said. Last week, in a special report, Sakeliga noted that the government has accumulated so much debt since 2008 that interest payments to service its overall debt have spiralled up to nearly R100 billion per quarter as well.

"In other words, almost **all government borrowing currently is being used to cover interest obligations from previous borrowing.** Not a healthy place to be," it said.

Meanwhile, other state and government entities, such as large state-owned enterprises and municipalities, have racked up hundreds of billions in new debts since 2008, with a rising expectation that these debts will be guaranteed or bailed out by the national government. Therefore, actual and probable liabilities of the national government have soared in the past 15 years, while infrastructure investment has either been neglected or wasteful, and economic value added has stagnated. "The result is that South African government bonds are less trustworthy than they once were. Lenders require higher interest rates as compensation for taking the (rising) risk of lending to the South African government," it said.



According to Russell Lamberti, the executive director for research at Sakeliga, a deteriorating financial position brings forward immense risks, including pressure on the rand and banking system, desperate politicians pushing for short-term wins to maintain power, and ultimately failure of the state.

“Fiscal distress almost always goes hand-in-hand with accelerated state failure,” he said.

“While we see state failure as an opportunity to build a healthier and more independent business environment, swift failure in key areas exposes businesses and communities to a rapid onset of more crime and violence, infrastructure decay and administrative collapse.”

“South Africa’s fiscal problem is not a tax problem,” he said, “it’s a spending problem.”

“South Africa is a high-tax country with a comparatively high rate of tax compliance by global comparison. Tax receipts are a higher percentage of GDP today than at any time in the previous 45 years for which we have data.”

Adjusting for inflation, tax receipts are higher in 2023 than they were before the Covid-19 lockdowns, and around 50% higher than in 2008. “This is not a tax problem. What is evidently lacking is spending restraint and responsible fiscal management,” he said.

WEAKER RAND, TAX HIKES AND MORE CORRUPTION

The government’s “persistent inability” to cut spending and address chronic waste in procurement signals the other risks.

“Although short- and medium-term fluctuations in the exchange rate are hard to predict, fiscal stress portends a less resilient and more volatile currency, which harms business and investment conditions,” Lamberti said.

“Fiscal risks are also a direct threat to the stability of the local banking system, not only because government is a major employer and spender in the economic system, but more directly because government bonds are a major asset holding of banks. A bond market crisis, as occurred during the 2020 lockdown, leads to a banking crisis and commercial credit crunch.”

On policy risks, the director said that diminishing tax receipts and public resources lead to governments desperately seeking to escalate policies that would extract resources from productive sectors of society. “This can include tax hikes, printing money and regulatory devices to extract levies, fees, fines, patronage and control for government officials, including asset grabs like special wealth taxes and land expropriation,” he said. Finance minister, Enoch Godongwana, has already alluded to possible tax hikes coming to help South Africa pull out of its financial crisis.

“We should expect enhanced efforts by the government to escalate BEE, raise taxes and close loopholes, tighten rather than loosen exchange and capital controls, add regulations to scoop fees and levies, and escalate corruption,” Lamberti said.

“SOUTH AFRICA’S FISCAL PROBLEM IS NOT A TAX PROBLEM, IT’S A SPENDING PROBLEM.”

INCREASE TAXES FOR THE WEALTHY

But cutting spending is not the way to go, the Institute for Economic Justice said over the weekend.

In a report written by Gilaad Isaacs, Zimbali Mncube and Liso Mdutyana, it said government should rather raise taxes on the rich to cover any shortfalls.

“The government should cut tax breaks that only benefit higher income earners and the wealthy. The removal of subsidies for retirement provisions could raise R97 billion. Removing the medical credit for those earning above R500 000 per annum could add an additional tax of R6.4bn. The under-taxation of wealth in SA cannot continue, offering large untapped revenue-raising potential.”

WHAT SHOULD INVESTORS DO?

I know I sound like a stuck record, but investors urgently need to increase the dollar-based investments in their portfolios. This can be done via asset swaps (the easiest), the R1m single discretionary allowance (SDA) and the R10m offshore investment allowance. In a full-blown debt crisis these dollar-based investments will be invaluable.

MAGNUS HEYSTEK | CO-FOUNDER, DIRECTOR AND INVESTMENT STRATEGIST AT BRENTHURST

MAGNUS HEYSTEK is a co-founder, director and investment strategist at Brenthurst Wealth Management. The company was established in 2004 and manages more than R18bn on behalf of its clients. It has nine offices across Gauteng and the Western Cape in South Africa, as well as an office in Mauritius. Heystek is the author of several books on investing, retirement and personal finance and an established public speaker regarding money and investment-related topics.

Tel: +27 (0) 11 799 8100 | **Email:** magnush@brenthurstwealth.co.za