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Debt must be invested, not consumed

Co-Pierre Georg, Hylton Hollander, Michael E. Rose[1]

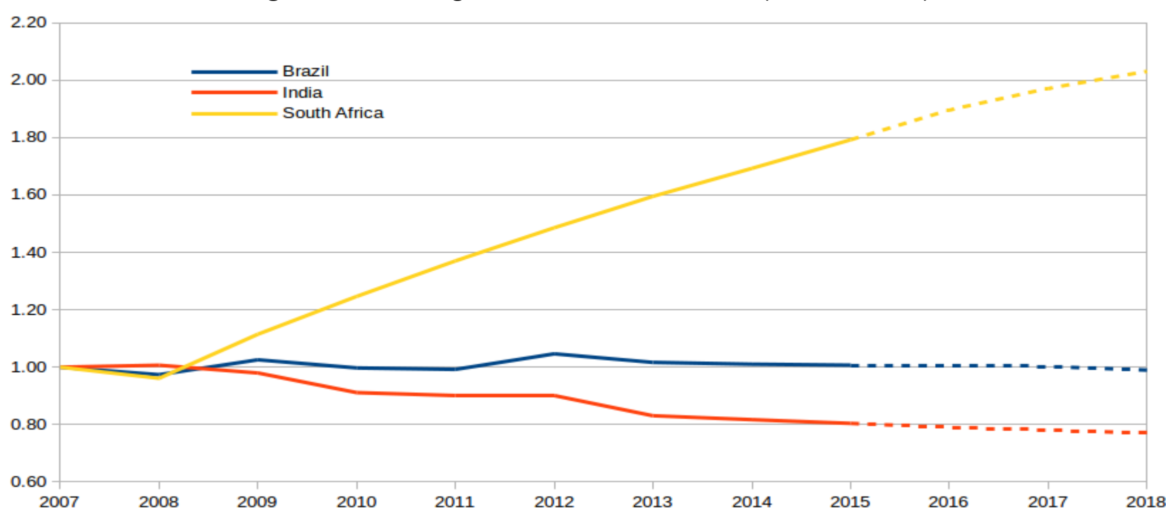
International capital flows often follow what Charles Kindleberger called a *debt cycle*. A young debtor country has net external debt, which it increases even further by running a current account deficit. A mature debtor runs a current account surplus, which repays the external debt. At some point, the young debtor country turns into a young creditor and builds net claims on the rest of the world. Finally, a senior creditor country has net savings but runs them down in a current account deficit. South Africa is facing the risk of being stuck in the status of a young debtor country because debt taken on today is not invested, but rather consumed.

We look at recent trends in debt, government consumption and investment to shed light on excessive and unsustainable debt accumulation. Unsustainable government debt levels translate into a lack of productive investment and/or too much consumption coupled with little prospect of income growth.

Stylized Fact 1: South African Debt Levels are high and rising sharply

Budget plans so far indicate that South Africa will accumulate about R550bn (about 15% of 2013's GDP) of new debt over the next three years. South Africa's debt peaked at 45.2% of GDP by 2013 - a 60% increase from 2007. It is expected to be near 60% of GDP by the end of the decade, according to IMF forecasts. Brazil and India, in comparison, are keeping their debt-to-GDP ratios stable or even reducing them (Figure 1).

Figure 1: Central government debt-to-GDP (index = 2007)



Source: Own calculations based on Federal Reserve Bank of St. Louis (2015 and beyond: IMF forecast)

[1] All authors are with the African Institute for Financial Markets and Risk Management (AIFMRM) at the University of Cape Town. The first author is also with Economic Research Southern Africa (ERSA).

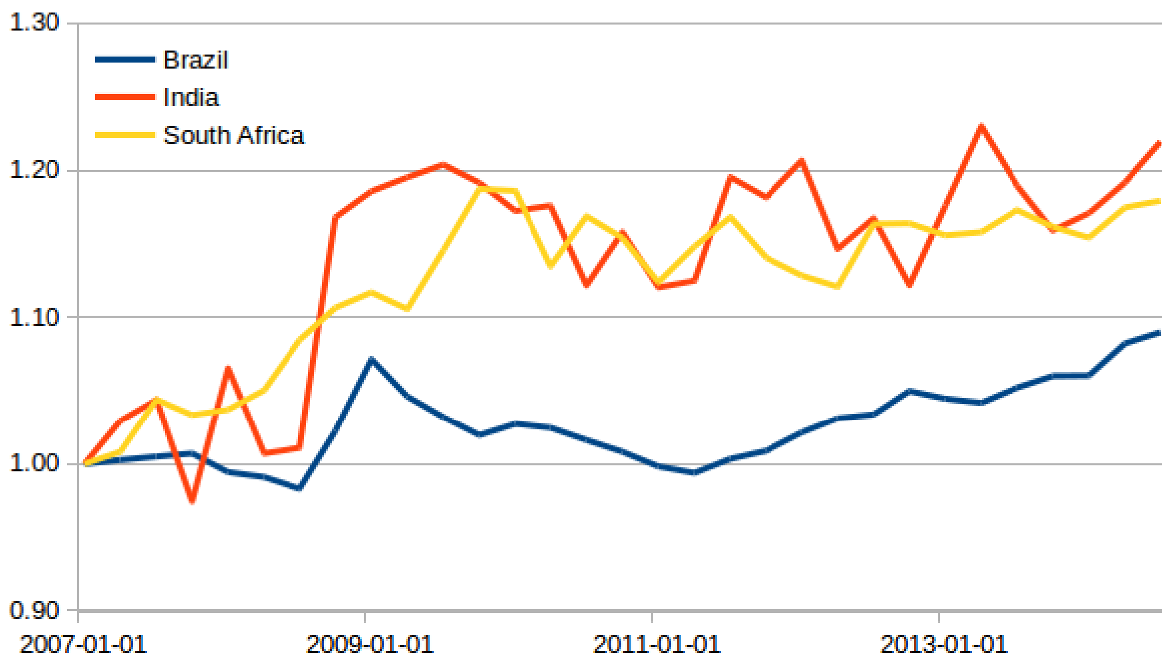
Forecasts by National Treasury are, however, more optimistic: It expects to stabilize debt levels at 43.7% of GDP by the 2017/18 fiscal year (IMF forecast for 2017 is 10 percentage points higher).

Stylized Fact 2: Too much consumption, too little investment

Whether or not a country will enter the beneficial debt cycle that Kindleberger described depends on whether debt is invested or consumed. In South Africa we are observing a tendency to increase in non-investment related expenditure. The share of GDP South Africa funnels into consumption increased slightly during the last seven years (Figure 2). In the same time, the share of GDP invested has stagnated (Figure 3). In its current budget review, Treasury schedules R1,000bn dedicated to health and social protection, while less than R700bn are scheduled for investment purposes.

More new programs that would increase consumption expenditure are underway: some estimate the recent public sector wage negotiations to lead to additional costs of R61bn; the National Development Plan proposes new welfare programs; the state-owned enterprises Eskom and South African Airways will continue to put pressure on the budget.

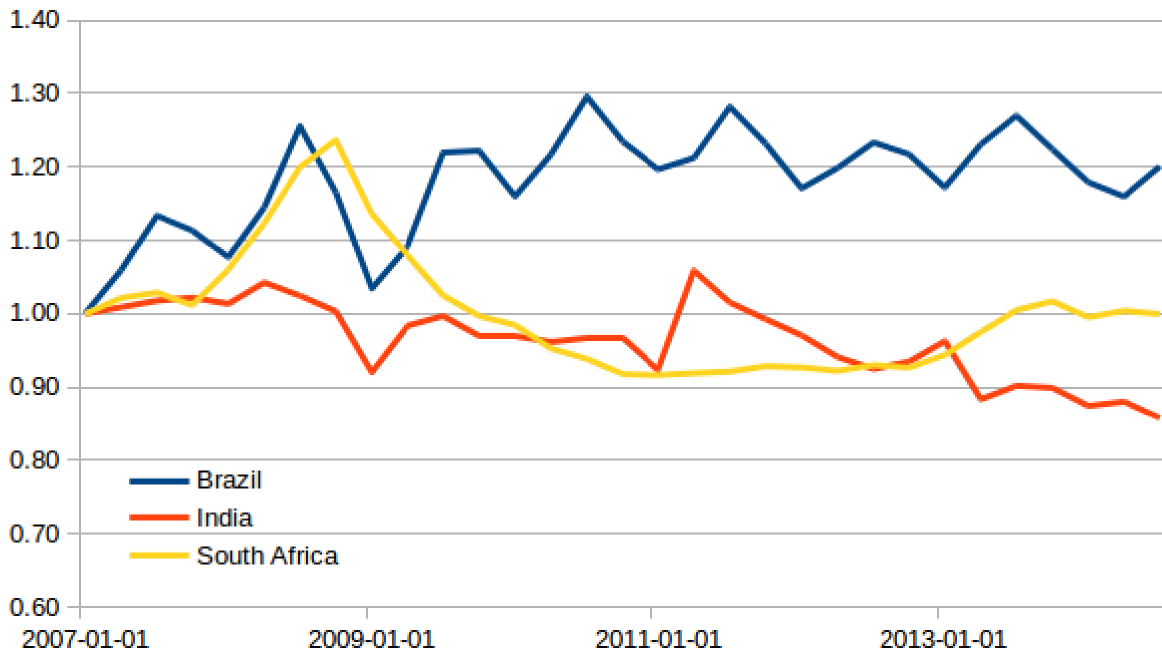
Figure 2: Government final consumption to GDP (index = 2007)



Source: Own calculations based on Federal Reserve Bank of St. Louis

On the other hand, there is little prospect of growth: National Treasury expects year on year growth rates for the next two years to be less than 2.5%. Debt levels growing larger than GDP are a common sign of unsustainable debt levels. If economic activity is not growing enough, the tax base doesn't expand, and not enough funds can be raised to service debt. The lack of investment today translates into a lack of taxes tomorrow - which will make it even more difficult to pay back the money that was spent on welfare programs.

Figure 3: Gross Fixed Capital Formation to GDP (index = 2007)



Source: Own calculations based on Federal Reserve Bank of St. Louis

Policy conclusions

South Africa is raising debt at a high pace. New debt is unlikely to be funnelled into productive investments, but rather into consumption. South Africa's Government should consolidate consumption expenditures by focusing on core policies. In doing so, more productive investments can be realized. In its recently published country report, the OECD emphasizes both electricity and transport provision as sectors where investments would yield high social returns. Moreover, as re-emphasized in the IMF staff visit in June, better management of existing infrastructure will unlock substantial efficiency gains. The NDP is already a step in the right direction.