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Rising debt-to-GDP ratio risks turning into a financial nightmare

The problem with debt is that it has to be repaid; another problem is that debt costs money.

In the past few financial years, the finance minister has been budgeting for a fairly large fiscal deficit.

During the 2007-08 financial year, a surplus of R19.4bn, equal to 0.9% of gross domestic product (GDP), was achieved. However, the good times didn't last, and since 2007 state revenue took a huge knock as the international financial crisis also forced the South African economy into a recession.

Since then, state revenue improved somewhat but remains below its peak of 27% of GDP in 2008. State expenditure, however, did not follow a similar trend, with the resulting deficits; now budgeted for R182bn, or 5.2% of GDP, for the next financial year.

The fiscal deficit is the amount of extra debt that the minister borrows to balance the books of the state, and is added to the existing debt pile.

But deficits are not necessarily a problem. If the state borrows less, relative to the size of the economy, than the rate at which the economy expands, then the debt-to-GDP ratio will fall. This means that, although the state's debt may increase in nominal terms, every time the minister runs a deficit, it does not mean that the state's debt as a percentage of GDP will necessarily increase.

But that was not the case in Wednesday's, and the previous three budgets, where the deficit-to-GDP ratio was higher than GDP growth. In the budget, the deficit is budgeted at 5.2%, which is higher than the expected GDP growth of 2.7%. The result is that the debt-to-GDP ratio is expected to be more than 40% by the end of 2013-14. In nominal terms, debt is expected to reach R1,522bn in the coming financial year, from only R577bn, or 23% of GDP, in 2008. This is a nominal increase of more than 160% in just six years.

That brings us to the next debt problem: the cost of servicing it. From 1994 to 2005, the percentage of total state expenditure that was consumed by the cost of debt varied from a high of 17.1% in 1996 to a low of 10.8% in 2005.

During the same period, the yield on 10-year government bonds ("interest" on debt) varied between 16.8% and 7.6%. But this "interest rate" on state debt started to decline only when it became clear that state debt relative to GDP was on a solid downward trajectory.

Additionally, since 2006, the average cost of debt came down markedly because of other factors, such as better credit ratings, but also because the cost of capital was intentionally kept low by the world's central banks. So, despite the state's recent rising debt burden, the cost of debt (interest mostly) is expected to consume only 10% of total state expenditure in the coming fiscal year.

Herein lies the potential danger. Although interest rates are likely to remain low for quite some time, the day will eventually arrive when central banks will start tightening monetary policy again. Further, even if central banks keep short-term interest rates low, longer-term interest rates (which affect most of the state's debt) can still increase when inflation accelerates or if there is another credit downgrade. The last time state debt relative to GDP was in the mid-40% range, 10-year bonds were trading at between 14% and 17%, which is double the current level. Therefore, should the cost of capital increase to the previous levels, when debt was at similar levels relative to GDP, the interest component can increase dangerously rapidly.

At a 10-year bond rate of about 7.5%, the servicing cost of "new" debt will be about R10bn in the first year. At a yield of 15%, this will double and add additional debt equal to about 0.3%. In subsequent years, this cost will keep on increasing as old "cheap" debt is replaced with new expensive debt (in some instances even "old" debt costs will go up — instruments such as the inflation-linked bonds are an example).

Depending on various factors, South Africa's state debt levels can potentially approach 50% of GDP in a matter of three years, in a worst-case scenario.

The state is not facing a debt trap and we still have time to reverse the present trends that will eventually lead us into financial difficulties. But the danger remains that the combination of high deficits, low growth and a sudden increase in the cost of debt can turn a deteriorating picture into a nightmare sooner than expected. It's better to be safe than sorry.

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