THE EXTERNAL SOLVENCY AND LIQUIDITY POSITIONS OF SOUTH AFRICA

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When analysing the potential of a country to service and pay back its external debt, there are two issues to be considered, the first one is solvency and the second is liquidity.

Traditionally, the solvency indicator most widely used has been Gross External Debt as a percentage of GDP that in the case of South Africa is 30%.. Some analysts argue that, because GDP is so sensitive to exchange rate movements, exports should be used instead. I do not think that this is the right indicator. It is better to adjust GDP, using a long-term sustainable equilibrium exchange rate, which is less volatile than the spot exchange rates.

Taking into account the 24 most important world emerging economies South Africa ranks 11th (better than the average) in terms of Gross Financing Requirements for 1999 as a percentage of GDP (13%) and using an adjusted GDP by a long term sustainable equilibrium exchange rate, South Africa ranks 3rd with 31% of GFR/GDP, one of the best.

Nevertheless, a much better measure to measure solvency is to use Net External Liabilities. Unfortunately, very few emerging countries use the IMF approved methodology for estimating external assets. A country may have increased its external debt but used part of it into foreign asset accumulation. In the case of South Africa it is very clear that many South African companies and individuals have increased their stock of assets abroad to diversify their investments, either through foreign direct investment or portfolio investment. Therefore, it is possible that its net external liability position could be much lower in terms of GDP than its Gross External Debt.

There is even more controversy regarding the best way to assess liquidity. For many years analysts have focused on the ratio of debt service to exports. Which in the case of South Africa is 17% (around the average). But this ratio is also problematic. The rating agencies use it partly because its similarity with ratios used to analyse companies, but a country is not a big company.

There are a few arguments to understand why, sometimes, such a ratio can be misleading, specially, in the globalised world in which we live.

For instance, a country has an external debt service of 10. It specialises in the production of motorcars of which exports 10. Therefore the ratio of debt service to exports is 1, but the inputs are manufactured locally, and therefore, the export sector generates a trade surplus of 9. The same country creates a free zone area at the border with its neighbours clients. Capital flows pour into the country to take advantage of cheap labour and low tariffs leading to an exchange rate appreciation. This puts some of the local manufacturers out of business. Imports of auto parts become much cheaper. The country imports 19 of auto parts, reassemble them, and sell them back at 20 to their neighbours, generating a trade surplus of only 1, but achieving an external debt service to exports of 0.5. The country has become a better credit despite a shrinking trade surplus.

Another argument is based on the recent experience in Brazil and Asia, where the ratio has proved to be a poor indicator of a country's ability to generate external liquidity. Once the crisis strikes, export financing collapses and so do exports. This is why, most academics and policy makers have gradually shifted away from debt service to export ratios to focus in alternative measures of foreign exchange liquidity.

The two most popular indicators today are the ratio of foreign currency reserves to some broad monetary aggregate and the ratio of foreign currency reserves to external short-term debt. The first one has the problem that the more develop and sophisticated is the domestic financial system, as it is the case of South Africa, the lower the ratio.

South Africa is not well ranked in either one, 8% of Reserves/M2, that is, ranked number 23rd, and 50% of reserves to external short term debt, that is, number 22nd. That means that either reserves are low or short-term debt is high. South Africa's international reserves represent only around 6 billion US $, a low level when it is compared to other emerging countries of similar size like Argentina, with 32 billion or Poland with 28 billion.

What can do the South African government to improve the ratio of liquidity? We all know the South African government's strong dislike for short term debt, which has been associated in many emerging economies with liquidity and banking crisis. The average maturity of its domestic debt is one of the longest of all emerging economies, 9,6 years. Only 25% of outstanding debt maturity is less than five years, another 25% is between five and ten years and 50% is over then years. Moreover, given that some long term financing is hard to obtain in the domestic capital market (although the South African one is much more developed than the emerging countries average), the South African government seeking an even larger extension of debt maturities is resorting to international capital markets and this is what it has been doing for some time. The good results of such an strategy are measured by the level of yearly amortizations as a percentage of total (domestic and external) public debt. South Africa has one of the lowest ratios, (the fourth lowest with only 8.3% in 1999), of all the emerging economies.

That shows that the South African government is following a prudent financing strategy by reducing gradually the public deficit and by extending the debt maturities both at home and in the international capital markets. The only problems with this strategy is that, on the one side, the international market for long term debt is less stable than that for short term debt and is almost exclusively denominated in hard currency, and, on the other side, if the government does too much long term borrowing in the international capital markets, it could, eventually, reach a large currency mismatch, given that most of its assets are in domestic currency.

There are two potential ways out of these problems. A first alternative solution is to increase foreign long term savings by enhancing inflows of foreign direct investment. South Africa has made an effort by obtaining in the period 1993-1998 an annual average of 800 million US $, but this is not enough. The experiences of other countries, in Asia and Latin America, shows that the best way to attract FDI is though deregulation and privatisation. South Africa needs more of both.

A second alternative solution is to create a larger domestic financial market for long term debt, but this takes time, because it is necessary to build up a large pool of long term savings. The only way that emerging economies have been able to enhance long term savings has been through the development of a fully capitalised pension system. The example of Chile, followed by Argentina and now by Mexico is a great success. They have used most of the privatisation proceeds to fund the initial capital of the new pension system. Given the present level of total national savings in South Africa, only 15% of GDP, such an strategy is a real challenge for the years to come.

<u>EXTERNAL DEBT RATIOS OF LEADING EMERGING ECONOMIES</u>

Total External Debt/GDP: <u>South Africa 30%</u>	Best: Colombia (13%) and India (18%) Worst: Hong Kong (258%) and Ecuador (108%)
Gross Financial Requirements/GDP: <u>South Africa 13%</u>	Best: China (3%) and Venezuela (6%) Worst: Hungary (40%) and Czech Republic (35%)
Gross Financial Requirements/Adjusted GDP*: <u>South Africa 31%</u>	Best: China (13%) and India (21%) Worst: Ecuador (155%) and Russia (107%)
Debt Service/Exports of G&S: <u>South Africa 17%</u>	Best: Malaysia (6.5%) and Poland (8%) Worst: Colombia (47%), Indonesia (44%) and Argentina (44%)
Foreign currency reserves/M2: <u>South Africa 8%</u>	Best: Venezuela (82%), Russia (67%) and Peru (66%) Worst: Korea 8%) China (10%) and South Africa 8%)
Foreign currency reserves/Short term debt <u>South Africa 50%</u>	Best: Venezuela (634%) and Chile (482%) Worst: Korea (45%), Russia (55%) and South Africa (50%)

* GDP adjusted by GSDEEMER: Goldman Sachs estimate of equilibrium exchange rates for emerging economies