Out of the Ordinary®

Investec
Group Economics

The deteriorating sovereign debt crisis and South Africa's financial system

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Figure 1: South African banking sector's credit exposure to selected peripheral European countries

	Number of South African banks with exposure	Net exposure (including collateral)[1] (R millions)
Greece	3	98.17
Ireland	4	242.24
Portugal	5	86.15
Spain	3	516.64
Total exposure to selected peripheral European Economies		943.21[2]

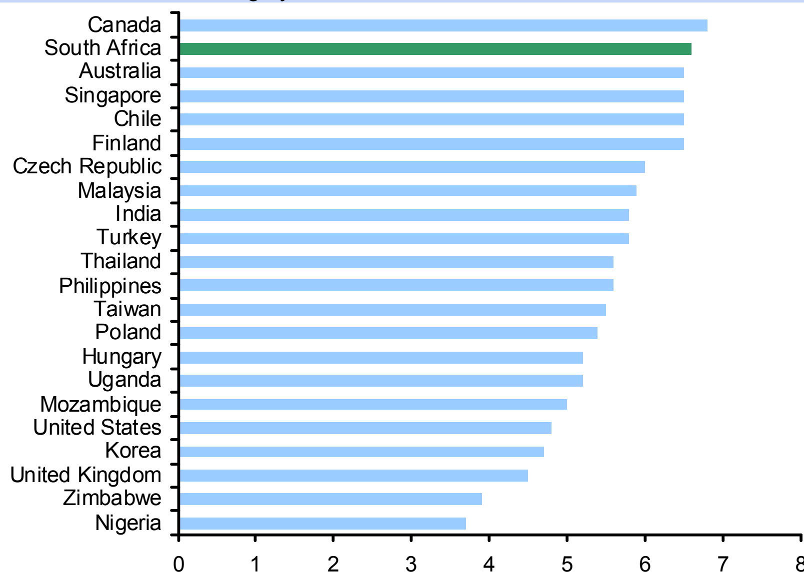
Source: SARB

1. Net exposure refers to aggregate on and off-balance-sheet credit exposure repurchase agreements and derivative instruments after applying collateral, 2. Figure may not add up due to totals in rounding

The deterioration in the sovereign debt crisis over the last few months has substantially increased risks for global economic growth and financial systems. In particular, the spiral in many eurozone bond yields, as lenders lose faith in the sovereigns' abilities to meet their debt obligations, is fuelling a run which, if not convincingly halted, would end in a Lehman style default. Higher yields cause market participants to become more risk averse, which then sends yields even higher, pushing up risk aversion levels once again, and the ensuing self-fulfilling crisis of confidence drives a run on bonds. The 2008 Lehman meltdown occurred as depositors lost faith in banks, the bank-run halted by government guarantees on financial institutions. Clearly the eurozone needs to take rapid steps to prevent this worst case outcome. Measures range from placing a temporary ceiling on sovereign bonds issued by governments following responsible fiscal polices, joint liability of eurozone members (the issue of eurobonds instead of individual countries continuing to issue debt) to the ECB becoming a lender of last resort (guaranteeing the banks not bonds) providing unlimited amounts of liquidity backed by the EFSF. But the key is that the eurozone acts rapidly, further prevarication will increase the likelihood of a financial crisis, and the concomitant risk of recession globally and locally in SA. We ascribe a 45% chance of such an outcome as markets are already clearly signalling their impatience with the unnecessary tarrying of the euro region in finding a solution to its debt crisis.

The risk for SA is economic, rather than financial sector contagion. South Africa's financial system remains well capitalised, with no liquidity problems and a low level of gearing. Indeed, it was these characteristics which prevented it from participating in the previous global banking crisis. No additional liquidity had to be provided to domestic banking institutions, sparing government finances, while lower gearing and less reliance on international capital markets protected SA from the worst of the credit crisis. Besides the sound characteristics of SA's financial system (see figure 2), its banking system has a negligible total

Figure 2: Soundness of banking systems



Source: Global Competitiveness Report

Note: 1 = insolvent and may require a government bailout , 7 = generally healthy with sound balance sheets

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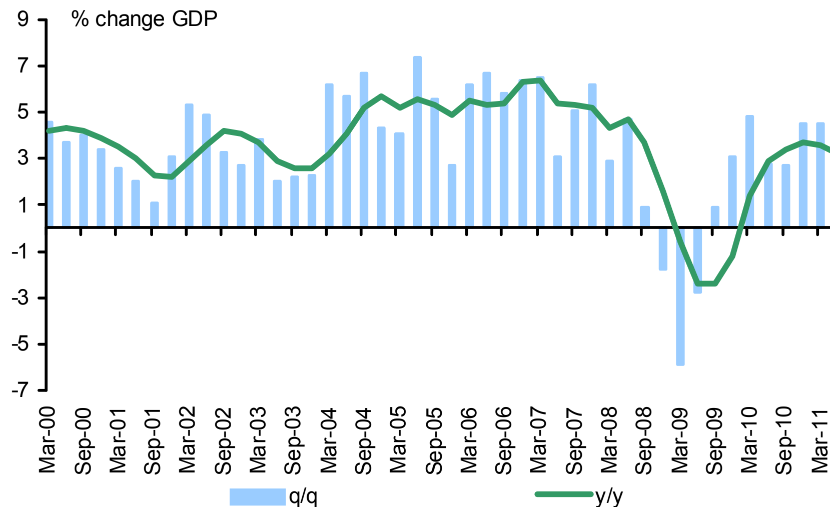
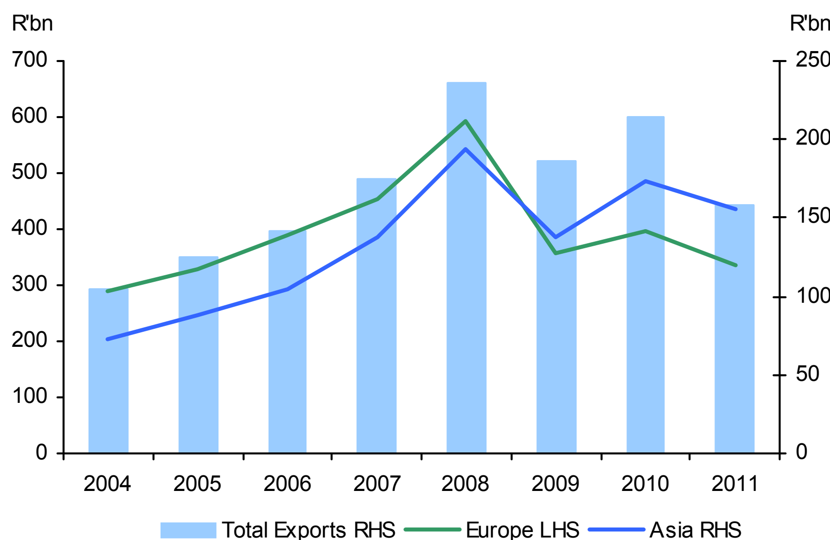
Figure 3: South Africa's economic growth



Source: SARB

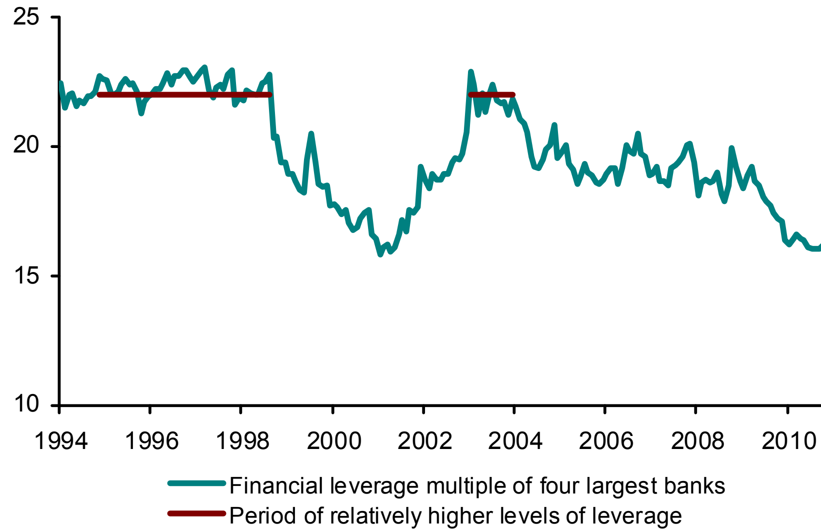
credit exposure to Greece, Ireland, Portugal and Spain (only R1bn, or 0.03% of total banking-sector credit exposure, see figure **1** in June this year). The South African Reserve Bank says that the bulk of this exposure was to financial institutions (including banks) with only limited exposure to corporates. No direct exposure was reported *at all* to sovereign counterparties. However, financial stability is closely tied to economic growth, and the majority of advanced economies are experiencing economic activity that is frail at best. The current synchronised downturn in many advanced economies is of concern because it could spill over into a global downturn, impacting already weakened financial systems and exacerbating the pressure on public finances around the world (reducing government revenues). As we said previously, the direct impact on SA's financial system would not likely be significant. The Reserve Bank's high level of financial market supervision and protection provided by the few exchange controls still in place means SA did not have a banking crisis in 2008/2009 and government borrowing was accordingly unaffected. The ongoing maintenance of high-quality capital and liquidity buffers well above the minimum macro-prudential requirements, resulting in SA's banking system recently being rated second in the world in terms of soundness (see figure **2**), means that a meltdown in our financial markets remains unlikely even if a Lehman style default occurs in the eurozone. Moody's is likely being too harsh in placing SA on credit watch in expectation that recent fiscal slippage reduces the ability to bail out SA's banking sector as risks for financial systems climb globally.

Figure 4: SA's key export markets



Source: SARS

Figure 5: Financial leverage multiple for the four largest banks in South Africa



Source: SARB

SA has experienced eight successive quarters of growth since the 2009 recession, but activity is now slowing on the back of the global downturn, with 3.0% y/y recorded in the second quarter of this year (latest data available) from 3.5% y/y in the first quarter (3.8% y/y in the last quarter of 2010 see figure **3**). As a small, open economy SA's economic performance is heavily influenced by global conditions and the worsening of the sovereign debt crisis has taken its toll. While Asia replaced Europe as SA's chief export market in 2009, this is due to the shrinkage of the European economy and not the outperformance of Asia on its own - SA is exporting less in real terms. SA's real value of exports (R437bn) has not regained levels experienced in 2005 (R444), let alone the heady pace in 2008 (R522bn). A Lehman style default in the Eurozone bond markets would provide a negative shock to SA's growth, exchange rate and inflation. South Africa would likely experience the last few months of 2008 once again, where the rand leapt to close to R11.00/USD from just above R7.00/USD. The global recession which begun in 2008 led to South Africa experiencing just three quarters of contraction, but losing close to a million jobs that are yet to be replenished.

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