

The debt blowout

Global economic update: August 2011

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Debt remains the hottest topic across global markets as the US flirts with defaulting and Europe agrees to a further bailout to stabilise Greece, Ireland and Portugal.

The US faces the worst debt crisis in its history

At the time of writing this newsletter, the world was waiting on the US Congress to decide whether or not to increase the US debt ceiling by \$2.5 trillion.

Over the past few years, the US debt ceiling has been ratcheted up on a regular basis. The current debt ceiling, which sits at \$14.3 trillion, was reached on 16 May. Currently the US government is meeting its financial obligations through a number of accounting tricks, including suspending investments in retirement funds. Basically, the US government is no better at managing its finances than most indebted households.

As a result of this indebtedness the US faces the very real risk that its AAA credit rating may be downgraded. The US has always had a AAA rating but this could change considering that Standard & Poor's (S&P) has placed its US AAA long-term and A-1+ short-term sovereign credit ratings on CreditWatch, which has negative implications. S&P uses CreditWatch to indicate a substantial likelihood of it taking a rating action within the next 90 days, or in response to events presenting significant uncertainty to the creditworthiness of an issuer.

According to S&P, there is at least a 50% chance that they could lower the long-term rating on the US within the next 90 days. If that happens, the rating could drop by one or more notches into the AA category.

EU bails out Greece

In the meantime, the European Union has engineered a further bailout package for Greece in an effort to stabilise the sovereign debt crisis in the euro area. The package includes extending the period of the loans and lowering the interest rates of the loans.

The package, an estimated €109 billion euro (R1,09 trillion), amounts to an extensive and generous restructuring of Greece's debt aimed at stabilising the sovereign debt crisis in Greece, Ireland and Portugal and preventing the crisis from spreading more fully to Italy and Spain. The markets responded favourably to the announcement of the bailout package.

The Greek government will have to continue stabilising its public finances which means increasing taxes and cutting back on spending – which will not be popular with its citizens. It also has to reform the economy, including privatisation. Greece has a long and very difficult road ahead but the current support package should prevent an immediate crisis.

As part of this agreement, the EU reaffirmed its commitment to the euro and to doing whatever is necessary to ensure the financial stability of the euro area. All EU countries have committed to reducing their budget deficit to 3% of GDP by 2013.

In the rest of the world...

Germany surprisingly strong

Germany, the largest economy in the euro area, has performed particularly well.

In Q1 2011 Germany's GDP grew by amazing 6.1%q/q (annualised) reflecting broad-based growth. Confidence levels are extremely high, the unemployment rate is 7% (the lowest level since the reunification employment data started in 1992), exports reached a record high recently and there has been a surge in tax revenue resulting in a lower budget deficit and reduced bond issuance.

On the negative side, inflation has been above 2% for five consecutive months.

China engineers a slowdown

Developing Asia, which includes China and India, has continued to outperform the other regions of the world convincingly. China has been trying to engineer a managed slowdown of domestic economic activity, partly in order to combat inflation, but also to control price developments in the housing market.

China's interest rates have risen by 125 basis points in five steps since October 2010, bringing the lending rate to 6.56% and the deposit rate to 3.50%. The government's massive two-year (\$586 billion) stimulus programme adopted in late 2008 has also ended.

As a result, economic activity has been slowing down gradually following the strong performance in 2010. Exports have remained strong this year and rising wages have helped boost consumption, but the booming property market is showing signs of softening and industrial activity has slowed. The Chinese economy is still expected to grow by 9% for the year.

Sub-Saharan Africa continues to grow

A number of other emerging economies have also maintained a consistently strong performance, including sub-Saharan Africa.

During 2010, sub-Saharan Africa grew by around 5% and in 2011 is expected to expand to around 5.5%, rising to 5.9% in 2012. However, there is a wide divergence in performance across the region. Resource-rich countries have attracted an increased inflow of foreign direct investment (including increased flows from sovereign wealth funds) and there is a renewed focus of multi-nationals on gaining greater access to Africa, using South Africa as the gateway.

Many challenges remain including: improving governance; reducing poverty and unemployment; strengthening public financial management and enhancing infrastructure. Addressing these issues will be key to raising living standards, moving to a higher growth path and attracting more foreign investment.

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