Safe for now

By Marie Antelme, Coronation's chief economist

This time around, SA has been spared being stripped of its investment-grade rating. But the country should be on high alert. The risk has not gone away: All three agencies have SA on a negative outlook.

S&P this evening announced that it had lowered SA's local currency rating (from BBB+ to BBB), while holding its foreign currency rating unchanged at BBB-, and maintaining a negative outlook. Its local currency rating is still a notch above the foreign currency rating. S&P's statement said the agency was concerned that political events are detracting from economic reforms, while low growth remains a drag on economic performance and the country's fiscal position.

Both Fitch and Moody's have already updated the market on their rating position. Fitch decided to move its outlook from stable to negative, but maintained its BBB- rating for both local and foreign currency debt. Moody's reiterated that it was communicating an update (rather than an affirmation, or 'ratings action'). It left its rating of Baa2 for both local and foreign debt unchanged and held its negative outlook.

While their ratings methodologies differ, the rationale of the credit rating agencies was broadly similar: growing political noise and infighting will increase policy uncertainty, weakening business and consumer investment. This is expected to continue through to the 2017 ANC elective conference. As a result, already weak growth is likely to persist. Taken together, low growth and policy uncertainty (overlaid with political flux) are likely to undermine necessary progress with fiscal consolidation.

Why do credit ratings matter?

Sovereign ratings are important for two main reasons.

Firstly, ratings send investors (and citizens) a very clear signal about the quality of a country's policy, fiscal and economic management.

Ratings are also important for government funding. SA runs both a fiscal deficit (estimated at 3.4% of GDP this fiscal year) and a current account deficit (forecast at 3.5% this year). Together, the country's total funding requirement (twin deficits) comes to a whopping 7% of GDP. SA is very reliant on foreign investors to help with this funding – a full 38% of government bonds in issue are held by foreigners. Not only do foreigners directly fund government, but overseas investments in SA assets fund our current account deficit.

Many foreign investments in SA bonds are dependent on the bonds being included in key indices, which are used as benchmarks for investment returns. To be included in these indices, specific credit ratings are required. For example, Citi Bank’s World Government Bond Index (WGBI) demands that a country has two local currency sovereign ratings above investment grade. (Some foreign bond fund mandates also require investment-grade sovereign ratings.) Downgrades could result in SA being excluded from the indices, which will ultimately see interest rates, and the cost of government funds, rise.

Vigilance necessary

For now, SA is not at immediate risk of falling out of an important global index. Despite revising the local currency rating lower, S&P still holds it above the foreign currency rating and both remain investment grade. Fitch and Moody’s have held SA’s local and foreign currency ratings in line with each other, and Moody’s kept both its ratings two notches above the investment-grade boundary.

However, the ratings agencies have clearly signalled that relative to the past (and other countries with similar ratings), SA’s capacity to repay its debt on time is somewhat diminished. This is not a good sign, and it reflects a combination of low growth (which is expected to persist) and a weaker fiscal position. SA hasn’t been able to meaningfully consolidate its deficit, which has resulted in a large increase in gross government debt from 28% of GDP in 2008/09 to about 52% at present. All three agencies have raised concerns about the political (and by implication policy) environment.

Without intervention, the path ahead looks uncertain, as downgrades don’t tend to happen in ‘ones’. Often the path to a weakened position has taken time to develop to the point of downgrade, which means there tends to be a lot of momentum behind it.

Once lost, regaining an investment-grade rating can be difficult. Just as the events which lead to a downgrade happen over time, remedial action will take time and will often demand immense political will to implement unpopular policy reform. Some countries which have been downgraded have not managed to regain investment-grade status.

How can SA avoid downgrades?

All the agencies have prioritised three things: a boost to SA’s slow per capita GDP growth rate; a consolidation in fiscal policy (to ensure an improvement in SA’s deficit and its debt-to-GDP burden); and less political instability, which is bad for growth and undermines both policy and economic institutions.

So to avoid further downgrades SA needs to bolster growth by implementing policy changes that will encourage investment and employment, and create an environment for improved business and consumer confidence. Government must follow through on National Treasury’s commitment to consolidate spending, and a political resolution is required to improve stability. We believe that there are a number of important structural reform initiatives being worked on that will help facilitate better growth, and that considerable effort is being made to consolidate government spending in a very tough environment.

What’s next?

Both Fitch and S&P follow a regular timetable for market updates and ratings actions, and are likely to publish comment again in June 2017. Moody’s has more flexibility and may make an announcement sooner than that – especially given that the statement issued now was an update and not a ‘ratings action’. This implies it hasn’t yet made a firm decision.

Credit ratings in context

A sovereign credit rating is an independent measure of a country’s ability to timeously meet its financial obligations. Because ratings are comparable across countries, financial markets use ratings to put a price on the risk assessment they represent. Countries deemed better (or best) able to repay their debt are awarded a rating in the ‘investment-grade’ range. Those more likely to default are considered ‘speculative grade’ or ‘junk’. Agencies also assign an ‘outlook’ assessment that signals a bias to the next move – either upwards for a ‘positive’ outlook, ‘stable’, or ‘negative’ if the rating criteria are expected to deteriorate further, prompting a downgrade. As ratings improve, or deteriorate, so too does the price at which financial markets are willing to lend to the underlying entity. This is important because the rate at which the government can borrow is the anchor for the rate at which all other agencies in a country can borrow – the starting point for lending.

There are three main ratings agencies globally: Standard & Poor’s (S&P), Moody’s and Fitch Ratings. They typically divide a country’s rating into a foreign currency rating and a local currency rating – the former reflecting a country’s willingness and ability to meet its foreign currency denominated financial obligations on time, and the latter its ability and willingness to meet all its financial obligations on time. Ratings typically take into account a range of economic, country and financial risks, and also consider the degree to which a country could rely on external assistance should it run into financial difficulties. The foreign currency and local currency rating can differ, although Moody’s usually rates the two the same. Despite efforts to create a rigid, numerically based and consistent framework, there is an element of subjectivity in the assessment process.