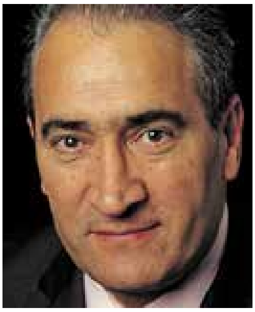
Avoiding SA's Junk-Grade Sovereign Credit Rating



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Nowadays, South Africa's (SA) sovereign credit rating is teetering on the brink of junk-status downgrade. President Zuma in his SONA 2016 highlighted the concern, and Minister of Finance, Pravin Gordhan, dedicated a significant part of his Budget Speech 2016 on 24 February, to the vital importance of avoiding a junk-grade rating at all costs. Precipitated by the so-called Nenegate of 1 December 2015, SA is at once gazing at the precipice of sub-investment grade credit rating. The country took ten consistent years from 1995 to 2005 to put its house in order to be fit for credit assessment first, and then a relatively sharp ascent to rising creditworthiness. As a result, the cost of borrowing for the state and for SA corporates declined sharply.

The Apartheid regime had left behind a country unfit for external credit assessment. After the birth of the democratic dispensation, a plethora of institutional restructuring, fine-tuning, and policy arrangements had to be put in place – all carefully and systematically coordinated. SA had to raise its credit rating to and above the 'investment grade' ranking as quickly as possible and position itself in the competitive global race for access to global capital within the peer country ranking. For SA with so much socio-economic backlog, together with a low and insufficient national savings rate, access to global capital markets was vital for the success of the new dispensation. That imperative has not yet changed, and will remain so for a long while still.

In the remainder of this paper, some of the concepts are fleshed out, the case for retaining the country's investment-grade rating is analyzed, and to this end some policy options are proposed.

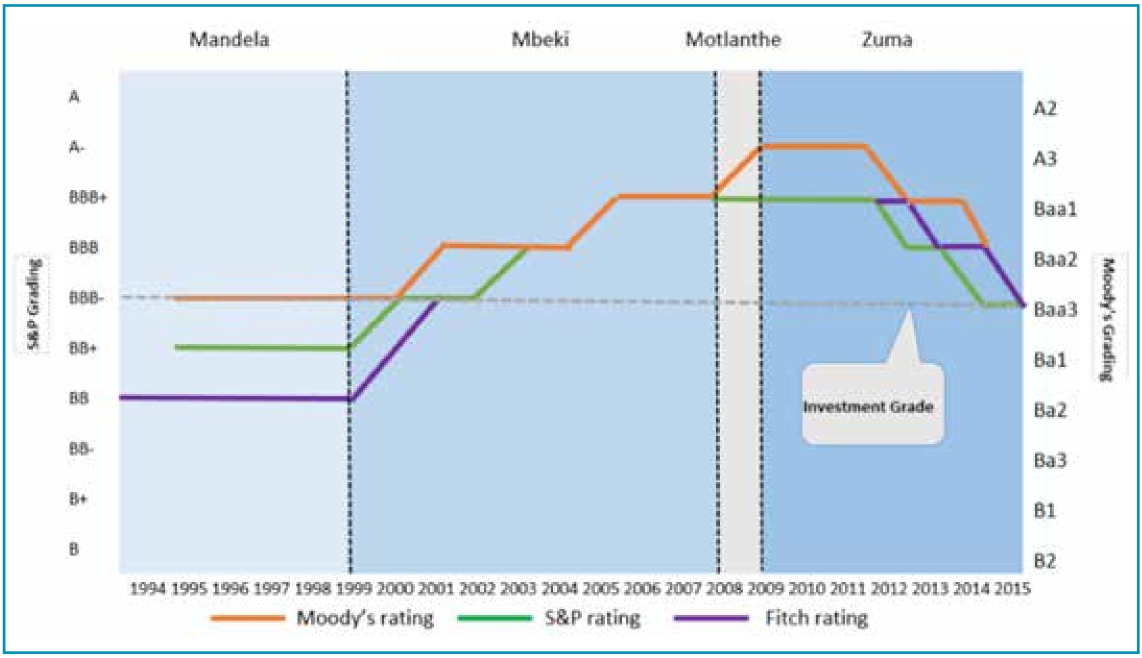
What is "junk- grade"?

A junk-grade, or sub-investment-grade, rating refers to the credit-worthiness of the borrowing entity, be it a corporate, a municipality or a national government. Whenever an entity faces a default possibility in the medium to long term, its bonds are rated as sub-investment grade. When the likelihood of default by the borrowing entity is high, the lenders in the capital market have a fiduciary responsibility to protect the interest of their institutions and/or investor members. More often than not, the capital market fund managers are using the pension or provident funds of a large group of workers, or the savings of a nation in a sovereign fund, to buy long-dated bonds that borrowers bring to the market. Some of these bonds may have a duration of 20 years or longer. For the lenders it is important to assess the likelihood of default over this period.

The rating agencies play a supposedly critical and impartial role in assessing the borrower's creditworthiness, providing a public technical ranking report. Importantly, such reports are produced at the behest of the borrowing entity. Whilst such reports are by no means perfect, they nonetheless establish an open matrix of financial and non-financial sustainability for the borrower. When it comes to national governments, the credit rating assessment involves not just financial but also socio-political variables that influence social stability, institutional capability, and policy certainty. Over time, the matrix of country-rating in particular has evolved to include variables on both the short-term and medium-term sustainability of growth, fiscal policy, and socio-political stability.

In general, the better a country's credit-rating, the cheaper it can borrow funds in the global capital markets. So, beyond and below the last investment grading levels, there are additional notches for upgrading or downgrading a government's creditworthiness. As such, the route to investment grade rating entails a complex blend of policy configuration, institutional structuring, sound governance, and competent financial management practices.

Conversely, a government facing a junk-status downgrade entails a sustained disregard for the country's growth dynamics, poor fiscal management, erosion of the public sector balance sheet and insensitivity to policy inconsistency over a number of years. South Africa over the period 2008 to 2015 has been a case in point. The country's sovereign credit rating has suffered as a result. It has been downgraded twice over the period, and now remains only one notch above the investment grade ranking (as graded by two of the three key rating agencies, i.e. S&P and Fitch[2]). The diagram below shows South Africa's credit rating history since 1994.



Critically, the fiduciary obligations of institutional investors prevent them from investing in countries with junk-graded status. More often than not, they are also obliged to exit their existing exposures and disinvest from such jurisdictions. This leads to short-term currency depreciation, added market volatility, and macroeconomic instability.

Why does it matter?

South Africa is a low saving nation. This is primarily due to the country's persistent high structural unemployment rate, accentuated by widespread poverty and working class poverty. As a result the national savings rate hovers around 15% of GDP whilst the required national investment for sustaining growth rates of 3% or more is well over 30% of GDP. This means unless South Africa can access other nations' savings, and be able to do so at reasonable rates, it cannot grow its economy beyond 1.5% on sustainable basis.

More specifically, the prevalence of the triple evils of unemployment, poverty and inequality means that the country has two concurrent requirements if it hopes to change the socio-economic configuration. One is sustainable economic growth averaging over 3% per annum; the other a resourceful, competent and developmental public sector. Importantly, both these requirements depend heavily on access to the global capital markets.

When a government credit rating is junk-graded, all the private sector corporates, state-owned enterprises (SOEs), and sub-national entities are likewise junk-graded for their global borrowing requirements. The cost of capital for the country as a whole rises accordingly. This leads to a decline in investments, economic growth, job creation, and tax revenues for the state. And, the longer it takes to end the junk-status, the more the business environment becomes constrained. This makes it harder for the state to deal with socio-economic imbalances and the restoration of macroeconomic stability. This in turn exacerbates the historic structural inequalities and social inequities.

The upshot of a rise in the cost of capital for the country, limited access to capital markets, and constricted business environment eventuates in a low-growth equilibrium trap – a far cry from the minimum growth rates needed for sustaining the developmental gains made since 1994.

Consequences of a junk-downgrade

There are two broad consequences arising from a credit junk-grade. One is political, the other financial. On the political front, when the government cannot borrow from the capital markets, its only remaining global source is to borrow from other governments and multinational institutions such as the IMF. This leads to a loss of sovereignty over national macroeconomic and sectoral policies. Typically, such funding comes with unpalatable and, often times, disruptive conditions attached. The notorious structural adjustments imposed by the IMF and the World Bank are cases in point.

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Minister Gordhan has been vocal on this potential loss of "policy sovereignty". In his Budget Speech 2016, he underlined this critical outcome, raising the clarion call to all South Africans, both in the public and private sectors, to do all within their powers to prevent a junk-status. The political implications of a SA government junk-downgrade extend beyond the borders of the country, having implications for the poorer neighbouring countries such as Lesotho, Swaziland, and Zimbabwe. It may be argued that the country's credit rating status will impact on its standing in the African continent, and more broadly internationally.

From a financial point of view, as mentioned above, the impact of a junk-downgrade destabilizes the macroeconomic framework. It confines the government borrowing largely to the domestic capital market, thereby causing systemic crowding-out effects. In the short term it leads to currency depreciation, escalating inflation, rising interest rates, and a fall in investments. Fiscal revenues decline accordingly, leading to rising tax levels, exacerbating an already depressed business environment. The cost of government borrowing grows, taking the budgetary framework towards fiscal stress. At present, the cost of public debt exceeds 11% of the national budget which is currently the fastest growing budgetary expenditure. The more this figure grows, the less is left for other essential public services such as healthcare, education, and social welfare. The ultimate outcome is a decline in the average national standard of living. Predictably, the public sector would be trimmed down and public services would suffer most. Poverty is likely to worsen, and social stability will become more fragile.

Who will suffer most?

The aforementioned cursory review highlights the fact that a junk-grade status has ramifications for the entire nation, both the rich and poor. However, to the extent that the poor have a high degree of reliance on public services, they suffer more in the short term. At present, over 16 million SA citizens receive monthly welfare payments of one kind or another. This has been a major public policy intervention to curb the plight of the poor. A major contributing factor that enabled the government to finance such large-scale redistribution was access to the global capital markets that facilitated the country's growth and rising tax revenues. Vastly improved fiscal management of public debt, cash management and a host of other factors also made a contribution. The country's rising creditworthiness helped reduce the cost of capital for not only the government, but also the private sector.

Alongside the poor, the younger generations too stand to lose a great deal – primarily due to economic stagnation, lack of employment opportunities, and limited scope for upward mobility. Typically, in such a milieu the country ends up losing a great deal of young talent and skilled labour. The medium term consequences of the mismanagement of the prevailing crisis of creditworthiness is thus deep and wide.

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How to avoid a junk-status?

Creditworthiness is a process and not an event. It entails a web of interrelated policy formulation, institutional structuring and governance, and fiscal management. All said and done, two factors enhance (or undermine) a country's creditworthiness. One is sustainable economic growth; the other sound fiscal management. Each of these two factors in turn has a number of basic requirements.

Economic growth requires sustained investment and socio-economic capital formation. Hence, business confidence is critical. Shoring up confidence, in turn, requires policy consistency and ethical governance. Sustainable growth, in particular, requires effective solutions for issues of poverty, unemployment, and income inequalities. The more these issues are dealt with, the fewer risks remain to the investment environment.

At the same time, sound fiscal practices are vital for the promotion of fairness and equity in society. The collection of fiscal revenues and an appropriate allocation and utilization of public resources form the very foundation of socio-economic prosperity of a nation.

Over the past decade, SA has regressed on these two fronts. As evidenced by recent data, economic growth has dwindled to well below 1% and public resource management has degenerated to dangerous levels and where the public discourse revolves around the possible 'capture of the state'. As a result the current crisis of creditworthiness has arisen.

To avoid a junk-downgrade, a systematic and coherent change of 'policy course' in the country's political economy management is needed. First and foremost, the political leadership should acknowledge the urgency of a step-change. To this end, the Minister of Finance in his Budget Speech 2016 called for such a clear step-change to avoid any further deepening of the crisis. It remains to be seen how the rest of the Cabinet will cohere around the Minister's clarion call. The rest of the economic cluster ministers have remained largely quiet, implicitly expressing discomfort and inability to change intellectual and behavioural course. This does

not help, particularly in light of the recent history of policy inconsistencies and contradictions displayed by the Cabinet Ministers since 2009. The urgency of the situation does not seem to have registered within the Cabinet. This needs urgent, visible and tangible resolution.

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Flowing from the position of the Cabinet is the restoration of good governance, competent management and rebuilding of the asset base of the SOEs. It is common knowledge that the SOEs have been the playground of patrimonial political leadership, crony-capitalism, and manifest rent-seeking over the past decade. As a result, their organizational integrity has been severely compromised, their balance-sheets hollowed out, and their corporate brands largely destroyed. They have become a considerable drain on the fiscus, undermining its creditworthiness. No government can achieve fiscal and financial sustainability in such a milieu. Nor can it hope to be effective in underpinning socio-economic development. As such, instead of playing "process politics" with these vital entities, bold and effective business turn-around strategies are needed. The corrective actions are fairly well known, and tested and tried solutions are readily available from the experience at home and the world over. No need to reinvent the wheel, and most certainly no time to lose.

The Private Sector has an indispensable role to play in avoiding the junk-downgrade. Whereas the above-mentioned Cabinet step-change and the restoration of the SOEs are critically necessary conditions, they, on their own, would not be sufficient to deal with the prevailing crisis. After all, the lion's share of investable resources and managerial capability lies with the private sector. And, as highlighted earlier, unless and until economy-wide investment flows are restored, economic growth would not result and, as such, the crisis would only deepen.

It is a fact that at present the private sector is largely skeptical, business confidence has sunk to its lowest level since 1994, and the macroeconomic environment is by and large unfavourable – thanks mainly to the political economy milieu since 2008. Yet, national interest as well as the enlightened self-interest of the business sector calls for a meaningful and urgent step-change on the part of the Private Sector too. Both symbolic and substantive changes are needed. In this regard the joint effort of the Minister of Finance and a large group of the private sector executives is a positive development – a necessary symbolic condition, but not sufficient. Other economic cluster ministers need to get involved. Furthermore, specific investment opportunities need to be identified in various sectors of the economy, their success conditions assessed and joint private and public sector efforts would need to be made to restore the growth trajectory. The credibility of the medium-term sustainability of the National Treasury's fiscal consolidation strategy would depend on the economy-wide investments made by the Private Sector.

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Civil society too has a vital role to play in enhancing the country's creditworthiness. Successful governance of modern societies calls for active and constructive citizens' participation in the promotion of good governance in public and private sectors, prevention of abusive and corrupt practices, and vigilance over constitutional institutions of governance.

Given South Africa's fractured past and its prevailing social tensions, civil society organizations have the added burden of contributing to the systematic and consistent elimination of the root causes of socio-political risks emanating from the evident societal failures of the past and the present. The subject is too broad to be fully analyzed in the confines of the present paper. Suffice to say, sustainable growth and development in modern societies require ongoing creation and augmentation of social capital. To this end, civil society organizations play a pivotal role.

Last, and not the least, of the role players in the prevailing credit crisis are the labour unions. Over the past decade, the trade union leaders have become the source of much political economy instability, disruptions at the workplace and the cause of labour unions implosion. All these in a period when technological innovations and the digital revolution have brought about tectonic and permanent changes to the skills profiles across all sectors of the economy worldwide. By losing focus on the binding structural and technological issues that affect job security and the welfare of their members, the union leaders have inadvertently contributed to the emergence of a business environment that lacks stability at the workplace and is not optimal for long term risk taking investments. Much like the government and the business sector, the trade union leaders too need an effective and transparent step-change.

To avoid a junk-downgrade, South Africa's key socio-economic and political role players need to 'reboot' – using the expressive jargon of the digital age.

Concluding remarks

SA faces a real crisis of creditworthiness in 2016. No amount of denialism, political spin doctoring or ideological posturing is going to avoid a deeper crisis which is likely to spread from fiscal-financial to socio-economic arenas. As explicitly highlighted by the Minister of Finance in his Budget Speech 2016, the crisis should not be wasted. Rather it has occasioned an opportunity for pulling back on track all the country's capabilities towards a new and powerful wave of patriotic, collaborative and constructive 'reboot' by all socio-economic and political stakeholders. However hard this may sound, the alternative is too ghastly to contemplate. A junk-status downgrade can be avoided. But it calls for a new mindset alongside urgent action by all those in key positions of leadership across our society.

NOTE

1 Nenegate refers to President Zuma's sacking of Minister Nhlanhla Nene on December 9th, 2015, replacing him with an unknown back bencher MP, Mr Des Van Rooyen. The President was persuaded to replace Des Van Rooyen after the markets went to a tail spin, causing tens of billions of rand damage to the SA economy, and throwing the country's policy credibility into serious doubt.

2 At the time of writing, Moody's has placed SA Government's rating up for review. Moody's rating of the SA government sovereign rating is two notches above the investment grade; chances are high that it will lower the rating and will be in line with the other two rating agencies.