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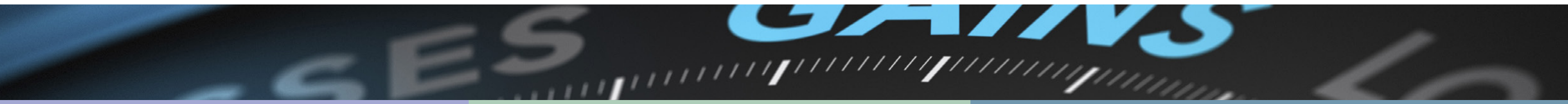

Economic Insights

February 2016

What would junk credit status really mean for SA?

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It is heartening that the National Treasury is working tirelessly to avoid South Africa's credit rating being lowered to non-investment grade. While there are differences between international currency credit ratings, which are often cited in the financial press, and local currency credit ratings, which are less spoken about, a downgrade to non-investment grade on either local or foreign debt would have a serious effect on the country.

A downgrade to non-investment grade (junk status) means a country has a higher risk of being unable to honour its debt commitments. As a result, investors require higher compensation for the risk taken, expressed in a risk premium. Junk status means investors have to reassess the risk premiums required when making equity valuations and bond pricing, and premiums paid on insurance against default.

Lessons from emerging-market countries

The best way to capture what typically happens when a country is downgraded to non-investment grade is to analyse similar countries. Looking at other emerging-market (EM) countries with similar economic constructs to SA -- employing inflation-targeting and floating exchange-rate regimes—potential outcomes from a downgrade to junk status are dire. Evidence from Colombia (1999), Romania (2008) and South Korea (1997) shows the downgrade has serious economic consequences and usually coincides with a bailout from the International Monetary Fund (IMF).

In the mid-90s, Colombia's budget deficit increased sustainably due to government commitments to social-service benefits and transfers to local government. This brought the country to its financial knees, resulting in a need for a US$2.7 billion IMF loan and a downgrade by Standard & Poor's (S&P) to non-investment grade. It took Colombia 12 years to return from junk to investment grade, with equities, bonds and currencies heavily depressed in that period.

Similarly, Romania during the 2008 global financial crisis was pushed to junk status after it needed a major IMF bailout (US$16 billion) and support from other supranational institutions, including the European Union and the World Bank. A rapidly increasing public sector wage bill and pension benefits, combined with robust credit creation -- especially in the real estate market -- left Romania's financial institutions vulnerable. When the global crisis erupted, the fiscus and banking sector experienced debilitating financial seizures. It took six years for Romania to return to investment grade.

South Korea provides an interesting case study. In 1997/98, given its large external debt levels, especially for state-owned enterprises, the country was caught in a current account crisis exacerbated by contagion effects from the rest of the EMs. Thailand and Russia ignited an EM crisis in the late 90s that also engulfed South Korea. However, its authorities acted swiftly by approaching the IMF for a bailout (US$35.1 billion) as rating agencies downgraded its credit quality four notches to non-investment grade. It took only 12 months for S&P to restore South Korea to investment grade after authorities in Seoul worked very hard to patch all the loose ends and do the necessary reforms.

Effect on investment markets

The response of asset markets depends on how long the country has junk status. Equity markets fall significantly during longer stays in non-investment grade, as was the case with Colombia (12 years) and Romania (six years). Shorter stays are better for currencies and equity markets, as witnessed in South Korea. Financial markets have priced-in SA to be non-investment grade as the country's debt is trading in global markets at similar levels to those rated non-investment grade, such as Turkey and Brazil. The machinations in the Finance Ministry during the latter part of 2015 left a huge cloud of uncertainty over fiscal policy.

If the response from the SA authorities results in an outcome similar to the Colombian experience, equity, bond and currency markets would be decimated over 12 years in non-investment grade. If the response is as agile as that of South Korea, outcomes in investment markets could be different and positive. In fact, a junk rating would prove a boon for astute investors as SA assets would become mispriced, creating ample investment opportunities.

After the 2008 financial crisis, there was a surge of investments into companies that had been downgraded to junk. These "fallen angels" continued to provide good management and a business infrastructure similar to those rated investment grade.

Similarly, fallen-angel countries, such as SA, which have a shorter time with junk status, retain their strong economic infrastructure even in their fallen state. It takes a very significant event such as war to completely wipe out the constructs of an economy and its institutions.

Will SA get dropped from the Citi WGBI if it is downgraded?

There is a difference between ratings of local currency (rands) issued debt and foreign-denominated debt issued in the Eurobond markets, for example. SA is rated higher on debt issued in rands (BBB+ by S&P), while the international rating on foreign-issued debt is lower (BBB-). On a local currency rating, SA remains firmly in investment grade. Although it is at the lower end of the investment grade spectrum in terms of foreign-denominated debt rating, a downgrade to junk does not automatically mean SA will be booted out of global bond benchmarks such as the Citigroup World Government Bond Index (Citi WGBI).

Table 1: How does SA stack up on Citi WGBI's exit criteria?

	Detail	Comment
1. Market size	US$69 billion	More than double US$25 billion minimum threshold
2. Credit quality	Long-term local currency S&P = BBB + Moody's = Baa2	It would take an 'Arab Spring' type outcome to be pushed into junk
3. Barriers to entry	Open and deep financial markets	No visible deliberate policy construct that prohibits foreign investors from replicating the All Bond Index (ALBI)

Source: Citigroup Global Fixed-Income Index Catalog – 2012 Edition, Bloomberg and Investment Solutions

Exit requirements of the Citi WGBI are that a country is downgraded on its local currency rating (not foreign) to non-investment grade by two rating agencies S&P and Moody's. Given that SA remains firmly in investment grade in terms of local currency ratings (BBB+), it is unlikely to be dropped from the Citi WGBI soon. In fact, it would take an "Arab Spring" type event to prompt rating agencies to push rand-denominated debt into junk.

Avoiding junk status

From where it currently stands, SA is far from an IMF bailout as it has buffers. External debt levels are low and the portion with short-term maturity is well covered by foreign-exchange reserves. SA has five months' worth of reserves to cover imports. It has deep and liquid financial markets that can withstand a financial shock. The trajectory is, however, very concerning. If things stay on the same path, there is an increased probability of a need for external financial assistance. While the Colombian, Romanian and South Korean examples of the descent to junk status were all accompanied by an IMF bailout, SA's financial constructs are different.

The 2016/17 February Budget to be tabulated in Parliament in a few weeks is arguably one of the most important since the dawn of a democratic SA in 1994. It is time for Finance Minister Pravin Gordhan to move away from the usual "difficult balancing act" rhetoric we have become accustomed to around budget formulations and provide clear and decisive leadership for the country's finances. This time around, stern leadership and bold moves are required.

The National Treasury should restrain growth in expenditure, especially on guarantees to state-owned enterprises. Plans to contain the huge public sector wage bill have not been satisfactorily implemented, which needs to happen. Care must be taken to avoid the introduction of new expenditure line items without a clear funding mechanism. Expenditure on nuclear power could prove very expensive. While tax increases can be used to shore up government coffers in the short term, the long-run effect of tax increases is detrimental to growth. Higher taxes are not a desired path for SA, which has huge socio-economic challenges.

Missed opportunity

The South Korean experience has demonstrated that being pushed to non-investment grade is not the end of the world. In a short time (a year), the country rose above junk status as authorities responded to the crisis with the utmost determination and clarity in policy formulation. Crises often breed opportunities to reform and improve economies. SA should not miss this opportunity to introduce structural economic reforms that could unlock the country's potential to achieve its National Development Plan goals.