Unpacking a downgrade

26 years ago, on Sunday 11 February 1990, Nelson Mandela walked out of prison a free man, to start a new life and to help give his country a new lease on life as well. A quarter of a century later the single biggest question hanging over the economy is whether SA will be downgraded to junk status in 2016.

What is a downgrade?

A downgrade occurs when two of the three internationally recognised rating agencies (Fitch, Moody's, Standard & Poor) grade a country as below investment grade or so called "junk" status. It then becomes more difficult for foreigners to advance you money and you have a cash flow problem. It is like going to an ATM and being told there are "insufficient funds".

It happened to SA in 1985 after PW Botha's Rubicon speech: Citibank said they would no longer make funds available, other banks followed, SA was shut out of international markets and had to declare a debt standstill. It was a traumatic shock to the body politic and contributed to the political transition.

Why is access to foreign money so important?

(This portion is a bit technical, but it is a vital question.)

It all starts with what a country **produces**, or the income it generates (GDP). If you deduct from that income what the country **consumes**, you are left with a balance called **savings**. Common sense really: income minus consumption equals savings. In SA savings in 2014 amounted to 14.9% of GDP. Think of it as 15c in the Rand. (The total rands came to R566.2 billion – so the 15c add up.)

From savings is deducted what the country **invests**. If it invests more than it saves the result is a deficit. In SA investment in 2014 was 20.3% of GDP, thus leaving us with a deficit of -5.4%. Call this the internal balance: the country's production (GDP) minus consumption and investment.

When a country runs a deficit, in other words its consumption and investment is more than what it produces, it logically means the country imports extra goods from other countries. "Extra" as in more than it produces; think of it as excess to production that gets imported. Thus the internal balance (production – consumption – investment) is equal to the difference between exports and imports, or the external balance. In 2014 that amounted to R206 billion – a sizeable amount to cover.

The last piece of the puzzle is that a country with an external deficit needs to go and find money to fund that deficit (the R206 billion). The funding is a combination of foreign direct investment, foreigners investing in the stock exchange, foreigners buying bonds and borrowing from international banks. If the country cannot attract that money, it simply has to import less. That means it must invest less and consume less i.e. have a lower living standard.

As long as foreigners are prepared to advance you money you can carry on running a deficit. That is how SA, and indeed many countries, operates and has operated for a long time. A downgrade restricts that freedom severely –meaning the freedom to invest in infrastructure and buy a reasonable living standard is restricted.

And who decides?

Enter the rating agencies. Discredited as they were during the Global Financial Crisis, rating agencies have a huge say in whether foreigners will help you fund your deficit. (Treat yourself by watching the recent movie *The Big Short* or the documentary *Inside Job* to see how rating agencies help feed the catastrophe.)

Rating agencies derive their power from three sources. Some countries, like the US, have national legislation that prohibits institutions (banks, pension funds, investment managers) from investing in countries which are not rated investment grade by at least two rating agencies. Secondly, the rules and mandates of many funds likewise prohibit them from investing in anything not rated "investment grade" by the rating agencies. Thirdly, even for institutions not bound by these rules, a downgrade increases risk perceptions and reduces willingness to advance money.

Tell-tale signs

South Africa has a very open economy with a free floating currency and a very liquid capital market. Two things will happen prior to a downgrade: the currency will depreciate sharply and long-term interest rates on the capital market will rise. Both have happened big time since early December when Mr Zuma fired ex-Finance Minister Nene.

The ten-year bond rate went from 8.5% to over 10%. It stood at 9.37% at the time of writing – a jump of 0.87%. It may look small, but the public sector borrows R150 billion a year, which means the **extra** interest payable on a year's debt was increased by some R1.3 billion, or more than R100 million per month. Insignificant it isn't.

The Rand's depreciation is well known and I do not have to elaborate on that.

So how much of the downgrade is in the price already?

Given the Rand's depreciation and the rise in the long bond yield, how much of the downgrade has already been discounted? Could the Brazil option be at work here – after a downgrade that country's currency and long bond rate improved? We simply do not know. Opinion in the market differs widely. (But someone is going to make big money betting on the right answer!)

It is interesting to note that foreigners have bought a net R2.8 billion in SA bonds so far in 2016. In 2015 they sold R15.9 billion. Clearly they think it is all in the price. But let's see.

Can a downgrade be avoided?

Two issues are at stake:

- a tight budget that will keep the deficit down and stabilise the debt to GDP ratio and
- SA's growth prospects.

The budget

In the interim budget statement in October then Minister Nene envisaged a budget deficit of -3.8% of GDP for this year, -3.3% for the coming year, declining to -3% of GDP by 2018/19. Since October growth prospects have dimmed so there is less revenue. Additional expenditure has been forced on the fiscus, primarily by drought relief, #Feesmustfall and other items.

But we also know from various public announcements that expenditure has also been cut. It is safe to assume that these new claims will not lift the October expenditure ceiling of R1.378 billion for this year and R1.45 billion for next year.

However, also important is the debt to GDP ratio. That was budgeted in October at 43.5% for this year, rising to 45.4% by 2018/19. Given the lower growth, expenditure would have to be cut below the ceilings mentioned above to keep to these ratios. If this ratio is not adhered to a downgrade is more likely.

One way to cut the budget deficit and debt to GDP ratio is by increasing taxes. Good for budget numbers, bad for growth.

Growth prospects

At least two rating agencies have set growth as a benchmark for a possible downgrade. When they said that, growth for this year was expected to be 1.2% and a bit more. Now it is expected to be half that….0.6% or even lower.

If the rating agencies stick to their word on growth they will have to downgrade SA. They may "downgrade" their own opinion on growth and settle only for good budget numbers, or they may not. If the latter, a downgrade is inevitable.

So What?

- SA runs an external deficit of between 4% and 5% of GDP – or R206 billion in 2014. That makes the country vulnerable as it needs foreign capital to fund that hole.
- The opinion of rating agencies has a huge impact on foreigners' willingness to provide us with the money.
- If we get downgraded to "junk" a lot of institutions who currently provide us with money will no longer do so.
- That means we will have to cut back on what we consume and invest less (big projects like power stations could be affected – nuclear perhaps?).
- A tight budget (i.e. lower expenditure ceiling and an unchanged debt to GDP ratio) will help avoid a downgrade.
- So will improved growth, but that will not come about in the short term.