South African Reserve Bank

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The evolution of South Africa's credit ratings[1]

Introduction

Good morning ladies and gentlemen.

I would like to thank the Council of Retirement Funds for South Africa for the opportunity to address you at the 2nd Batseta Winter Conference. The theme of the conference, 'Smart Practices for Thriving Funds' is also quite topical in the broader financial markets arena given the current low global interest rate environment, regular bouts of heightened market volatility and various challenges facing the industry. Such circumstances indeed require innovation and creative thinking. One such challenge, undeniably, is the issue of a potential sovereign credit rating downgrade to non-investment grade and its implications for South Africa - an issue clearly on everybody's mind, and quite topical given reviews by some agencies in the last few weeks.

Fortunately, the recent opinions from rating agencies were somewhat positive. On 6 May, Moody's affirmed the country's foreign-currency credit rating at Baa2 with a negative outlook. This came after Moody's put South Africa on review for a possible

[1] Compiled by Alta Joubert and Aadila Hoosain, Financial Markets Department, South African Reserve Bank.

downgrade. Moody's affirmation of the rating, despite having put the country on review, was a very positive development and surprised financial markets as a rating review usually leads to a ratings action. South Africa also has a negative outlook from Standard and Poor’s (S&P), mainly as a result of a significant downward revision to its growth forecast for the country.[2] Following its most recent review, S&P affirmed South Africa’s BBB-rating though they have maintained the negative outlook. As neither of these agencies downgraded South Africa, it indicates that they are waiting to see the effect of the recent measures introduced by the authorities and the private sector. However, as both Moody’s and S&P have maintained the negative outlook, we are not out of the woods yet and there is no room for complacency.

The evolution of South Africa’s credit rating

Perhaps it is best to start with a brief review of the history of South Africa’s credit ratings. South Africa attained its first formal credit assessment in 1994, and today, despite recent downgrades, we still enjoy an investment-grade foreign currency debt rating from four ratings agencies. S&P and Fitch’s rating are one notch above noninvestment grade (BBB-), Moody’s rates South Africa at Baa2, two notches above non-investment grade, while we have a rating of BBB+ from Rating and Investment (R&I), three notches above non-investment grade. The initial upward trajectory of these ratings started soon after the first democratic elections in South Africa. From the bottom of the investment-grade band by Moody’s (Baa3) and non-investment grades from S&P and Fitch (BB), the country’s sovereign rating by Moody’s improved to A3 in July 2009, which, at current ratings, is similar to countries such as Ireland, Malaysia and Peru. The peak in the ratings from S&P and Fitch was achieved in 2005 at BBB+, and one notch higher at A- by R&I in 2006. These ratings were respectively four (Moody’s and R&I) and three notches (S&P and Fitch) above non-investment grade.

The improved creditworthiness of South Africa reflected a sound economic landscape. This included the narrowing of the current-account deficit since the mid-1990s to a small surplus in 2002, while economic growth improved from a small

[2] S&P halved its GDP forecasts for 2016 in the December review from 1,6 per cent to 0,8 pent cent and from 2,1 per cent for 2017 to 1,8 per cent.

contraction in 1998 to an annualised growth rate of slightly more than 7,0 per cent in the second quarter of 2005. The country's ratio of government debt to gross domestic product (GDP) improved from around 50 per cent in 1995 to almost 25 per cent prior to the global financial crisis (GFC). The favourable economic backdrop and concomitant improved credit ratings lured foreign investors to South Africa's domestic financial markets. In the ten years prior to the GFC, non-residents bought a cumulative amount of almost R400 billion worth of domestic equities and just over R100 billion worth of bonds. The equity market rallied by almost 500 per cent over the same period while the ten-year government bond yield declined by about 800 basis points to around 7,0 per cent in 2005 and 2006.

While this gives us some history of the evolution in South Africa's credit rating, I will now elaborate on the more recent changes in our credit ratings, the impact on financial markets, and the contribution that the South African Reserve Bank (the Bank) can make to the overall credit worthiness of the country.

Key factors influencing sovereign ratings

As a starting point, it will be useful to make some cursory remarks around how rating agencies form their opinions and how this is applied to South Africa.

The Moody's analytical framework, which at a high level uses four key factors, is a useful reference point to understand the factors that drive credit ratings. The first factor is **economic strength**, which reflects a country's intrinsic ability to honour its debt obligations and deal with various exogenous shocks. Some of the key drivers of the economic assessment are the expected economic growth trajectory, potential economic growth and the diversification of the economy. For South Africa, economic growth metrics are a concern not only for authorities but for the rating agencies as well. As stated at the May meeting of the Monetary Policy Committee (MPC), the domestic economic growth outlook remains weak, with the Bank's GDP growth forecast for 2016 revised down from 0,8 per cent to 0,6 per cent. While a recovery is still expected in the next two years, the forecasts for both these years were revised down by 0,1 percentage points to 1,3 per cent in 2017 and 1,7 per cent in 2018, and the MPC assesses the risk to this forecast to be to the downside. This slow growth has led to real GDP per capita remaining largely unchanged in the three years from

2013 to 2015 at around fifty six thousand rand. According to the International Monetary Fund's April 2016 *World Economic Outlook*, the per capita income has declined from its peak of US dollar 8 090 in 2011 to and estimated US dollar 4 768 in 2016.

Shock absorption ability as measured by economic diversification remains a crucial factor for South Africa. While the country has a diversified economic base, a combination of bottlenecks arising from domestic electricity shortages and labour market issues, faltering commodity prices, and persistent low global economic growth have added pressure to various industries. In addition, the agricultural sector is under pressure due to the recent drought. From a microeconomic perspective, income distribution tends to be highly skewed. South Africa, one of many countries to suffer from this phenomenon, has a Gini-coefficient of close to 0,69.[3] Progress on improving income inequality has proved challenging over the years, with the Gini-coefficient registering 0,67 in the post 1994 era.

The second aspect of ratings is **institutional strength**, which is a key consideration for foreign investors who are considering investing in a country, though this does also affect local investor confidence. Institutional strength is derived from a transparent, credible and consistent policy and regulatory framework as set by the government and central bank. Such an environment provides the foundation for business and consumer confidence. South Africa generally does quite well in this regard. For example, the national budget process is highly transparent and respected globally, and the judicial system is seen as strong and independent. South Africa also scores better than its BBB-rated peers in the World Bank's governance indicators, benefiting from strong fiscal and monetary institutions. However, in some other areas, such as perception of corruption, South Africa does not perform that well.

The third factor is **fiscal strength**, which is primarily an assessment of the overall health of government finances. Governments which have a short debt maturity profile face significant refinancing risk. In South Africa's case, however, the weighted term-to-maturity of total government debt is 12,7 years, and National Treasury actively manages various risks associated with its debt portfolio. National Treasury's

[3] South African Poverty and Inequality Assessment Discussion Note, Draft 2016.

borrowing programme is underpinned by strategic benchmarks for refinancing, interest rate structure, inflation and currency risks, and as indicated in the February 2016 *Budget Review*, the structure of the debt portfolio remains well within its self-imposed risk limits. At the same time, South Africa's government gross debt to GDP ratio is expected to remain between 50 and 51 per cent over the medium term. While in line with the emerging-market average,[4] it is better than Brazil (76-81 per cent) and India (around 66 per cent). It is also noteworthy that only 10,0 per cent of South African government debt is denominated in foreign currency, reducing the exposure to exchange rate shocks. In addition, short-term debt is sufficiently covered by reserves. However, contingent liabilities in the form of government guarantees to state-owned enterprises (SOEs) such as Eskom and South African Airways are also factored in. Consequently, the health of our SOEs is important to our country's credit rating.

Lastly, **susceptibility to event risk** is also important for rating agencies. This criterion assesses whether sudden events or risks could materially increase the probability of default. These risks could emerge in the economic arena, the financial sector, from political instability, as well as natural disasters. I have already touched on South Africa's economic landscape so I will not discuss that again, but our financial sector deserves a mention. It is a well-regulated industry and we have a well-capitalised banking sector with the total capital adequacy ratio well above the regulatory requirement of 10 per cent. Our financial markets are also highly advanced, have good liquidity and a strong domestic investor base. However, the country's dependence on foreign portfolio financing to fund the current-account deficit makes it somewhat vulnerable to exogenous financial sector shocks.

My discussion so far has hopefully provided a reasonable, albeit rather succinct, explanation of the rating agency framework of thinking around credit assessment within the South African context. Further, it provides some background why, since 2012, South Africa has been downgraded by all four rating agencies. The common themes across the commentary from Moody's, S&P, and Fitch revolved around low GDP growth and structural weaknesses such as electricity generation capacity and labour market rigidities. In addition, a less friendly environment for investors and businesses also contributed to the downgrades and despite the initiatives stemming

[4] Fiscal Monitor, IMF, April 2016.

from the National Development Plan, according to Moody’s, many policies have weakened South Africa’s business confidence, leading to South Africa's decline in the World Bank’s ‘Ease of Doing Business’ index ranking to 73rd from its 69th position in 2015.

The view from the financial markets

While rating agencies are indicating their caution about the likely trajectory of South Africa's credit rating, financial markets also tend to anticipate the rating agency decisions ahead of time. One metric, namely the credit default swap (CDS) spread, has been pricing in an increased probability for a downgrade to non-investment grade since around September/October 2015. South Africa’s five-year CDS spread is trading at around similar levels to that of countries which have been downgraded to non-investment grade such as Brazil, Russia and Turkey. In fact, South Africa’s five-year CDS spread was trading at around 304 basis points (bps) on Friday, not much lower than the 343 bps where Brazil, a BB rated country, was trading. By comparison, Russia and Turkey, who's rating straddle investment and noninvestment grade ratings across different agencies, or so-called split ratings, were trading much lower around 260 bps. This is an indication that the CDS market has priced in a downgrade of South Africa’s sovereign rating to non-investment grade.

Looking at other markets, a similar trend is observed. In the currency market, the rand underperformed against other emerging markets since August last year due to adverse domestic developments and a weaker commodity terms of trade. In brief, various indicators reflected a slowdown in economic activity as well as deterioration in business and consumer confidence, and, according to data from the Johannesburg Stock Exchange (JSE), external vulnerability as non-residents sold R45 billion worth of domestic equities and bonds in the fourth quarter of 2015. This selling continued in 2016 with a further R35bn of net outflows for the year to end May.

The domestic bond market was also not spared. According to JP Morgan,[5] South Africa’s yield, which has traded between 100 and 200 bps over the emerging-market economies (EMEs) average since 2010, broke out of this range in November and is

[5] According to the JP Morgan Government Bond Index-Emerging Market (local currency bond index).

currently 300 bps over its peers. The deterioration in perceived creditworthiness is also reflected by the widening of the spread between government bonds and interest rate swaps. For example, the spread between the thirty-two year R2048 government bond and comparable interest-rate swap increased from around 50 bps in late September 2015 to 110 bps last week. Similar to domestic bond yields, data also compiled by JPMorgan show that the yield on our foreign-currency denominated debt, which has never traded less than 35 bps below the average for emerging markets and averaged around 75 bps below in recent years, moved to par with emerging markets at the end of 2015 but has recovered somewhat to 25 bps below more recently. The most recent level is still 50 bps weaker than the previous average.

These data indicate the importance of an investment grade status for a country. This is also confirmed by an IMF study showing that reaching investment grade lowers sovereign interest rate spreads by 36 per cent, over and above what is implied by macroeconomic fundamentals. This compares to a 5-10 per cent reduction in spreads following rating upgrades within the investment grade asset class, and no impact for movements within the speculative grade asset class. This study shows that an investment-grade rating reduces financing costs significantly, improves market sentiment, and encourages greater inflows from a more diversified investor base. This is of particular importance given South Africa’s reliance on foreign capital inflows. The market reaction to the possible downgrade of South Africa to non-investment grade supports the IMF findings and bears testament to the increased cost the country faces should its credit standing continue to deteriorate.

Other impacts of non-investment grade status on South Africa

While I have discussed the impact of non-investment grade status on the cost of financing in general, it is actually a more nuanced affair and we need to discern between the local- and foreign-currency ratings to better understand foreign investor behaviour. Typically, the public discussion will reference the foreign-currency rating as this rating is associated with foreign investors and tends to have more stringent criteria. And indeed, the foreign-currency rating does matter in that it sets a clear external reference point for investors, but foreign portfolio flows are also impacted by the local-currency rating. Global benchmark indices for domestic debt markets will usually reference the local-currency rating as this applies to domestic debt issues. These indices will often have a minimum credit rating and when a country falls below this level it will be excluded from the index, resulting in investors needing to liquidate their bond holdings in order to replicate the benchmark, also referred to as 'forced selling'. Out of seven indices[6] in which South African bonds are included, there are two indices which apply to domestic bonds and which are based on the local-currency rating, namely the Citibank World Government Bond Index (WGBI) and the Barclays Global Aggregate Index. Exclusion from these indices would require sub-investment grade, and based on South Africa's S&P local-currency rating of BBB+, South Africa will need to have another three downgrades to drop out of these indices.

As discussed earlier, I would like to highlight that markets already may have priced in much of the possible impact of a downgrade to non-investment grade. While a single-notch downgrade would not trigger South Africa's exclusion from these indices, investors will require a measure of additional compensation for the perceived increase in credit risk. A recent study by the South African Reserve Bank[7] (based on a sample of 70 countries) concluded that a downgrade in sovereign ratings from BBB- (the lowest investment grade) to BB+ (highest speculative grade) has the tendency to increase the average short-term bond yield by 80 basis points, and the average long-term yield by around 104 basis points. The recent underperformance in South Africa's bond yields and the concomitant higher cost of debt financing, will therefore likely become entrenched in our markets should we eventually be downgraded.

There are also important knock-on effects to other sectors which I will touch on later, but let me first make a few remarks with regard to economic consequences of a ratings downgrade to non-investment grade. According to a study by Standard Bank, countries that have gone through such an experience on average saw moderating economic growth in the period leading up to a downgrade, and ultimately ended up with even lower or negative growth rates after the downgrade. This was also

[6] Citibank World Government Bond Index (WGBI), JPMorgan Government Bond Index-Emerging Markets (GBI-EM), JPM EMBI Global, JPM EMBI Global Diversified (EMBIGD), JPM EMBI Plus (EMBI+), Barclays Global Aggregate Index and the Vanguard International Bond Index.
[7] SARB Economic Note, Sovereign credit ratings and cost of funding, Shakill Hassan, January 2016.

associated with their currencies coming under pressure and concomitant higher inflation requiring tighter monetary policy, which in turn contributed to the slower economic growth.

South Africa has already witnessed some of these effects. While the weak rand has been a reflection of concerns over the growth outlook for China, softer commodity prices, and increasing interest rates in the United States, it has also reflected concerns about South Africa and the outlook for its credit rating as the rand has underperformed its emerging-market peers. The rand has underperformed other emerging-market currencies since mid-September last year, depreciating by over 15 per cent versus an only minor depreciation in the JPMorgan emerging-market foreign exchange index. This contributed to the MPC's assessment that the risks to the inflation outlook are to the upside and the consequential increases in the policy rate.

Although domestic headline consumer inflation moderated to 6,2 per cent in April 2016 since the high of 7,0 per cent in February, the respite is expected to be temporary, as food and petrol price pressures continue to intensify. While the impact of the weaker exchange rate remains relatively low, there are indications of increased pass-through in some categories, particularly new motor vehicles and appliances. The most recent forecast of the Bank for headline consumer inflation shows that the breach of the upper end of the target range will be protracted and inflation is only expected to fall within the range during the third quarter of 2017. Inflation is expected to average 6,7 per cent in 2016 and in 2017 and 2018 inflation is expected to average 6,2 per cent and 5,4 per cent respectively, with the expected peak at 7,3 per cent in the fourth quarter of 2016. The MPC highlighted that the risks to this forecast are to the upside, amongst others, due to the exchange rate. While the future moves in the rand will be influenced by many factors, one cannot ignore the possible negative consequences of further rating downgrades. I have already discussed the Bank's growth outlook so I will not repeat that here.

Let me make one final point on the effects from a ratings downgrade on funding costs. Given that investors would require higher compensation for taking the higher risk associated with South African assets, in particular government bonds, yields will remain elevated. Since most other fixed-income securities are priced as a spread over the benchmark government bonds, these higher yields will spill-over to the bond and loan rates in the banking and corporate sectors, thereby increasing their cost of funding. Given the prominent role of domestic currency debt financing relative to foreign currency financing, and, as discussed above, the larger reaction in domestic currency yields, this will increase the cost of doing business without monetary policy tightening.

Of course, pension funds will also be affected by the spill-over from asset prices, especially bonds and equities, given their large exposure to these asset classes of 35 and 54 per cent, respectively. To that, I would like to add, that the volatility in bond and equity prices that were observed since late 2014, serves as a reminder of how abruptly prices can change, with significant effects on the savings industry. Official data show that pension funds' portion of total assets invested in cash is relatively low at only around four per cent, implying that price volatility will have a large impact on portfolio valuation. Therefore, anticipation of future ratings actions need to be considered in asset allocation decisions given the potential for re-pricing these assets.

What can the South African Reserve Bank do?

Having discussed the market reaction to credit ratings at length, let us turn to the role of the central bank. In this light, the most important contribution the Bank can make is to deliver on its constitutional mandate, which is 'to maintain price stability in the interest of balanced and sustainable economic growth'. This is carried out within a flexible inflation-targeting framework. By ensuring price stability, the Bank plays a key role in providing an environment in which businesses and households can flourish. A vibrant private sector will help generate growth which in turn will support the country's credit rating.

Secondly, the Bank plays a key role in protecting and enhancing financial stability in South Africa. This will be affirmed in the Financial Sector Regulation Bill (2015), which is expected to be promulgated later this year. However, the Bank recognises that it is not the sole custodian of financial system stability, but that it contributes significantly towards a larger effort involving government, other regulators, selfregulatory agencies, and financial market participants. By ensuring financial stability, the Bank will directly contribute to the institutional strength of South Africa, thereby supporting the credit rating.

As you will recall from my earlier discussion on the factors impacting on credit ratings, it entails various different segments of the economy and institutional framework. The South African Reserve Bank's role is to ensure that it has policies that are credible, transparent and reputable, and in the best interest of everybody in the country. Thus, the Bank, by ensuring that its mandate is implemented effectively, contributes to a positive assessment of South Africa by the rating agencies.

Concluding remarks

In conclusion, sovereign ratings are a reflection of a country’s macroeconomic, institutional and political fundamentals. We recognise the risks stemming from further rating downgrades, and while asset prices may have discounted rating actions ahead of time, all this means is that should a downgrade come, it will embed the higher costs for the economy. The recent pronouncements by Moody's and S&P have given us a window of opportunity to prevent more rating downgrades. However, the negative outlook indicates that we must remain focused and take appropriate and decisive action. Consequently, the Bank will continue to endeavor to provide an environment that supports a strong and robust economy through the pursuit of price and financial stability.