TIPS
TRADE & INDUSTRIAL POLICY STRATEGIES

POLICY BRIEF: 4/2020

The ratings downgrade

INTRODUCTION

The economic effects of Moody's recent credit ratings downgrade have been overtaken by the whirlwind effects of the COVID-19 crisis. It is, however, also important to understand the likely effects of the downgrade, which vary for different sectors and stakeholders, to ensure a reasoned response. This policy brief looks at the economic impacts of the decision. It also considers the policy implications. While the ratings agencies have indicated that changes in economic policies and practices could reverse the downgrade, these policy demands on South Africa are contradictory. They suggest that, to improve its credit rating, South Africa must reduce worker protections, limit land reform, and cut government spending. However, these measures would all in turn aggravate social inequalities and policy contestation, increasing investor uncertainty and risks over the long run.

PROBLEM STATEMENT

On 27 March 2020, Moody's joined Fitch and Standard & Poor to downgrade South Africa's sovereign rating to below investment grade (also known as "junk") status. That means all three dominant international ratings agencies see any investment in South Africa as relatively risky.

In practice, the extraordinary impacts of the global economic crisis due to the COVID-19 pandemic will swamp the outcomes of the downgrade. It is, however, worth pausing to understand the likely effects, which vary for different economic sectors and stakeholders, to ensure a reasoned response. In this context, it is particularly important to evaluate the policy recommendations incorporated into the justification for the downgrade.

Analysis of the impacts and justification for the downgrade leads to the following conclusions.

1. The downgrade's main direct impact is to accelerate the outflow of financial investments, in turn leading to downward pressure on the rand, higher interest rates for international borrowing, and lower share prices. These effects are not very visible, however, because the COVID-19 crisis had already led to a massive capital outflow and depreciation. South Africa is particularly vulnerable to changes in global financial flows, because from 1994 it saw disproportionately large foreign purchases of company shares and government bonds. One consequence is that South Africa's public and private foreign debt rose from from near zero in 1994 to above the average for upper-middle-income economies excluding China.

2. Some producers will gain and others will lose from the downgrade, the associated depreciation, and higher costs for international borrowing. The main losers are financial institutions, if international financial transactions shrink. Importers of both consumer and intermediate goods could also lose, since the rand price of foreign products will rise with depreciation. In addition, the National Treasury will end up paying higher interest rates – a particularly hard burden given rising deficits. On the other hand, exporters and local producers that compete with imports should gain, as depreciation makes their products more competitive with foreign suppliers. So should local producers of commodities such as iron ore, chicken, wheat and maize, whose prices in South Africa track international dollar-denominated markets. Purchasers of these products will, however, bear the higher costs.

3. In practice, the COVID-19 pandemic overshadowed the effects of the downgrade. By the end of March 2020, the pandemic had already fuelled a massive capital outflow and higher debt costs, offset somewhat by a spike in the gold price; sharply reduced the international cost of crude oil, which is South Africa's single largest import; and dampened demand for exports and imports irrespective of the exchange rate.

Trade & Industrial Policy Strategies (TIPS) is a research organisation that facilitates policy development and dialogue across three focus areas: trade and industrial policy, inequality and economic inclusion, and sustainable growth

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The lockdown from late March will lead to a significant fall in the gross domestic product (GDP) since most producers would have had to shut down for at least three weeks.

4. The ratings agencies justify the downgrade as the consequence of slow growth. They blame the sluggish GDP principally on policy failures combined with unusually deep economic and social inequalities, and the resulting conflicts over policy. That analysis ignores the overwhelming impact of the sharp decline in global mining prices from 2011, which led to a steep drop-off in export earnings and in the process dragged down GDP growth. Moreover, the ratings agencies' analysis is inherently contradictory. They suggest that, to improve its credit rating, South Africa must reduce worker protections, limit land reform, and cut government spending. These measures would all in turn aggravate social inequalities and policy contestation, increasing investor uncertainty and risks over the long run.

In short, a downgrade was almost unavoidable as growth slowed with global metals prices, although policy errors, especially around electricity and large-scale corruption, certainly aggravated the problem. In this context, the ratings agencies' policy analysis and recommendations simply ignore the fundamental structural challenges resulting from mining dependency combined with the deep inequalities and high joblessness left by apartheid.

The downgrade points to the need for economic policy to incorporate a more sophisticated and consistent understanding of business perceptions. From the standpoint of government, a core function of economic policy is to manage business to meet social aims while remaining economically sustainable. That requires a better understanding of the different fractions within business, which often have divergent interests. In the case of the downgrade, significant gaps emerge between importers and the financial sector, on the one hand, and exporters and local producers on the other. A challenge in this context is that the financial sector's highly developed lobbying capacity often drowns out the voices of other business groupings.

TRACKING THE IMPACTS OF THE DOWNGRADE

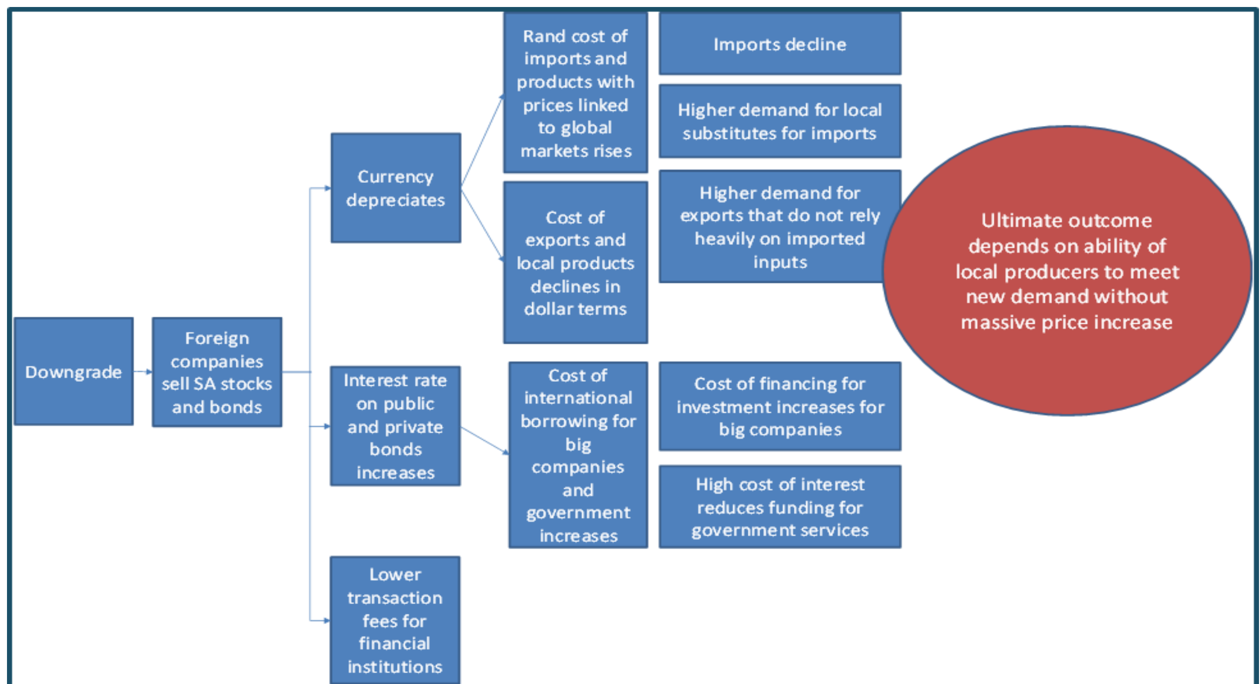
Figure 1 shows the relationships that shape the impact of the downgrade. The new rating means that financial holdings in South Africa are considered below investment grade (sometimes called "junk") – that is, too risky for normal investment, and especially for retirement savings. In practice, that means that long-term investors, and especially pension funds, will likely reduce their holdings of South African stocks and bonds. US retirement funds are legally required to hold only investment-grade instruments.

The anticipated sell-off of local bonds and stocks is expected to result in:

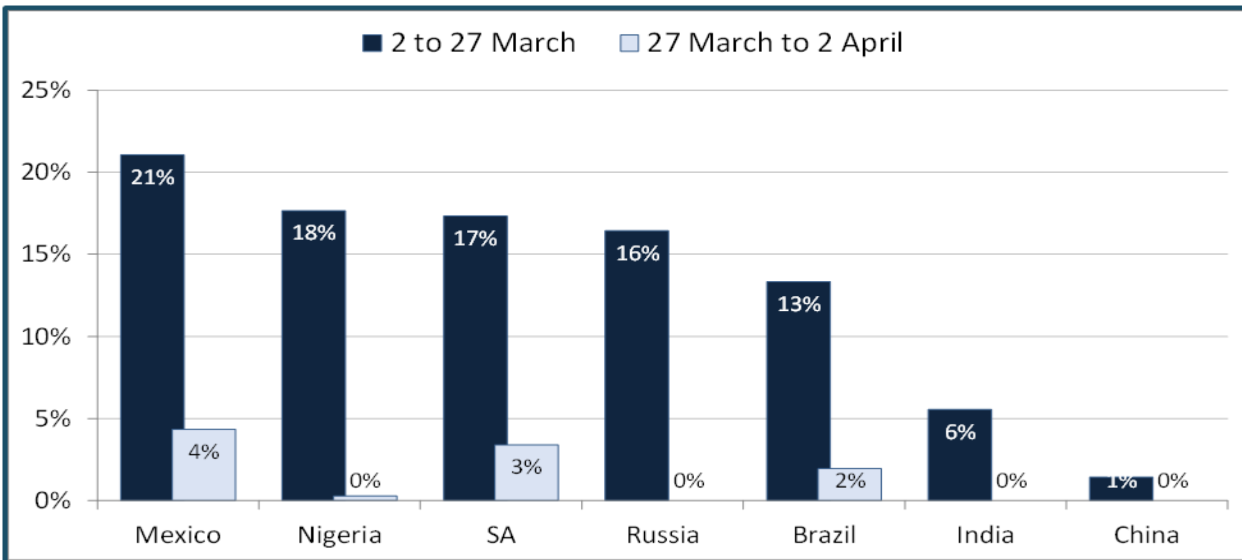
- Depreciation of the rand.
- Higher international borrowing costs for the government and large companies that issue international bonds, and lower share prices.
- A loss of income for financial institutions, both banks and brokerages, as international transactions dry up.[1]

[1]*Some analysts argue that international experience suggests that the value of international transactions will stabilise at a higher cost to South African borrowers and companies. In that case, the financial institutions will not see a decline in income, but costs will rise for government and large companies that use foreign funding.*

Figure 1. Theoretical effects of a downgrade



Graph 1. Percentage depreciation of local currency against the US dollar for major emerging markets, 2 March to 27 March and 27 March to 2 April 2020

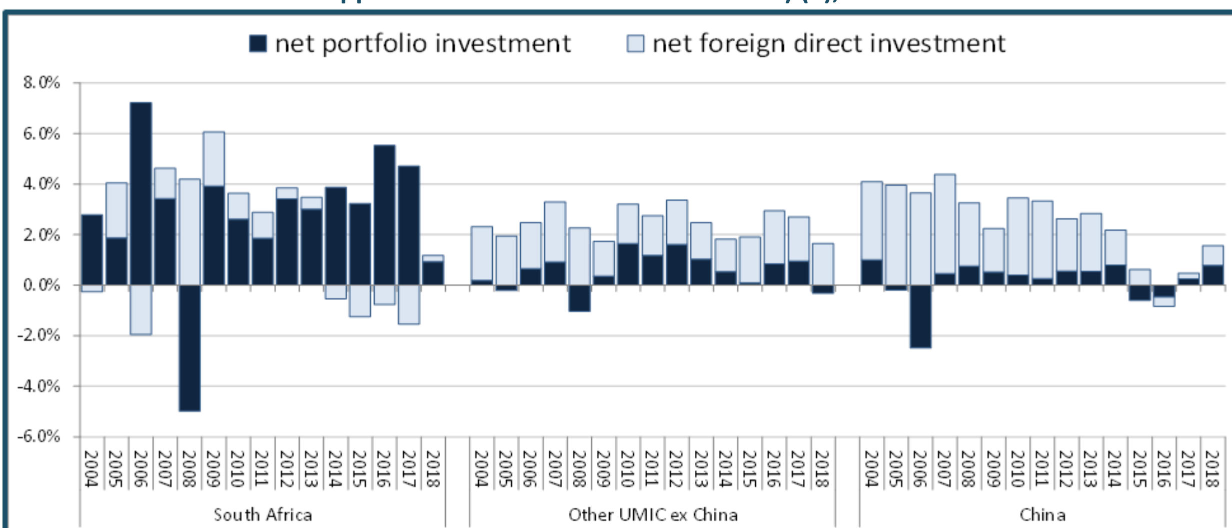


Source: Calculated from Trading Economics. Currencies. Interactive dataset. Downloaded from www.tradingeconomics.com at noon Southern African time on 2 April 2020.

- Higher rand prices for imports, mostly affecting better-off households and producers who use imported capital and intermediate inputs.
- Higher prices on locally produced commodities whose prices are effectively linked to the cost of competing imports or exports. These products include iron ore; chicken feed and consequently chickens; maize; sugar; and wheat.
- Exporters and local producers would see their prices fall in foreign-exchange terms. That would make them more competitive with foreign companies both in South Africa and beyond our borders. This advantage would be offset to some extent by higher rand prices on imported inputs.

While Figure 1 (page 2) indicates the theoretical short-run outcomes of the downgrade, in practice the the actual effects have been drowned out by the global COVID-19 crisis. The world's GDP likely fell sharply in March, although data are not yet available. In March, prices fell for virtually all South Africa's major exports except gold. The COVID-19 crisis also led to a huge outflow of funds from emerging markets into investments seen as less risky, especially US bonds. As a result, many developing economies, especially if they depend on mining or petroleum exports, saw a sharp depreciation against the US dollar from early March through early April (see Graph 1). On the brighter side, the price of petrol dropped from over US$60 in early March to under US$25 by the end of the month. Since petrol is South Africa's largest single foreign purchase, the decline partially offset the effects of depreciation on South Africa's import bill.

Graph 2. Net portfolio and direct investment flows as percentage of GDP, South Africa, China and other upper-middle-income countries UMIC) (a), 2005 to 2018



Note: (a) Covers 40 out of 54 upper middle income countries for which the World Bank provides figures. *Source:* Calculated from World Bank. World Development Indicators. Interactive data bank. Series on net portfolio and FDI flows and for GDP in current US dollars. Downloaded from www.worldbank.org in April 2020.

South Africa has seen unusually high foreign purchases of local stocks and bonds since the early 1990s, which heightens the effects of fluctuations in international financial flows. In contrast, foreign direct investment lagged behind other upper-middle-income countries. As Graph 2 shows, portfolio investment in South Africa was far higher relative to the GDP than in peer economies. In contrast, foreign direct investment equalled a much smaller share of South Africa's GDP. Moreover, South Africa saw an outflow of direct investment from 2014, mostly because of divestment from the mines as international prices fell. Portfolio investment remained robust in this period, however, until 2018 brought a decline. Data for 2019 are not yet available.

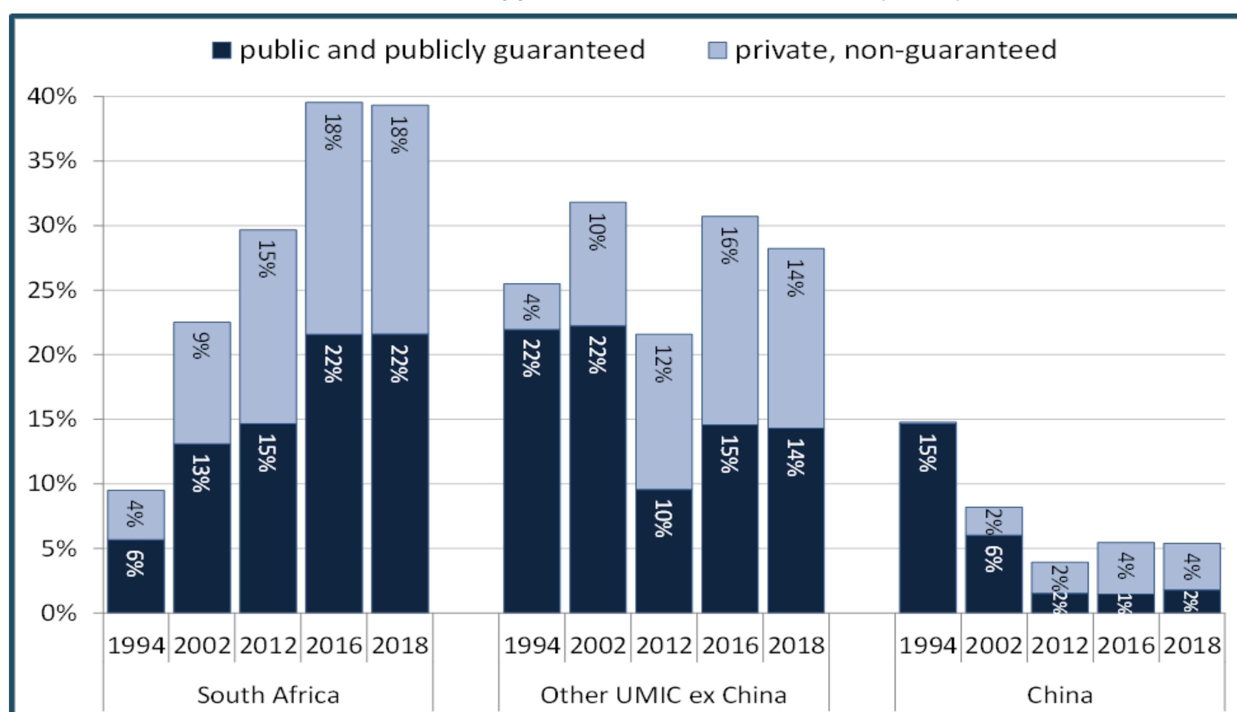
International ratings appear to have very little influence on foreign direct investment – that is, companies' investments in productive capacity as opposed to purchases of stocks and bonds issued by existing producers. As Graph 2 shows, South Africa saw limited foreign direct investment over the past 20 years compared to other upper-middle-income economies. Yet only a third of upper-middle-income countries had an investment-grade rating in early 2020. At that time, of all developing economies, 15 were rated investment grade, 43 as junk, and 81 had no rating at all, usually because they had never tried to issue international bonds. Of the 38 upper-middle-income economies with a rating, only 12 were investment grade. For high-income countries, in contrast, 43 are investment grade, seven are junk, and 28 (mostly very small states) are not rated. Upper-middle-income countries with ratings under investment grade in early 2020 included Brazil, Turkey, Argentina, Cuba and Namibia. Countries with investment-grade ratings included Russia, China, India and Botswana.

The effect of unusually large financial inflows into South Africa can be seen in the extraordinarily high value of shares on the Johannesburg Stock Exchange (JSE) compared to the GDP. In 2018, the JSE's market capitalisation was more than twice the value of the GDP. That ratio was exceeded only in Hong Kong, where the stock market capitalisation was 10 times the GDP (mostly because of listings by mainland Chinese companies). For other upper-middle-income economies, the figure was under 50%. For all countries with a stock exchange, it was under 90%.[2]

Foreign bond purchases also brought a sharp increase in overseas debt for both the government and large companies. Because the apartheid state was largely shut out of international borrowing from 1985, the democratic state had very low foreign debt. But the share of government debt held by foreigners climbed slowly to around 8% through 2011, then accelerated to reach 15% in 2019. As Graph 3 shows, both public and private debt stock climbed relative to gross national income from 1994 to 2017, surpassing the average for upper-middle-income countries excluding China (which had very low foreign debt over the past 25 years).

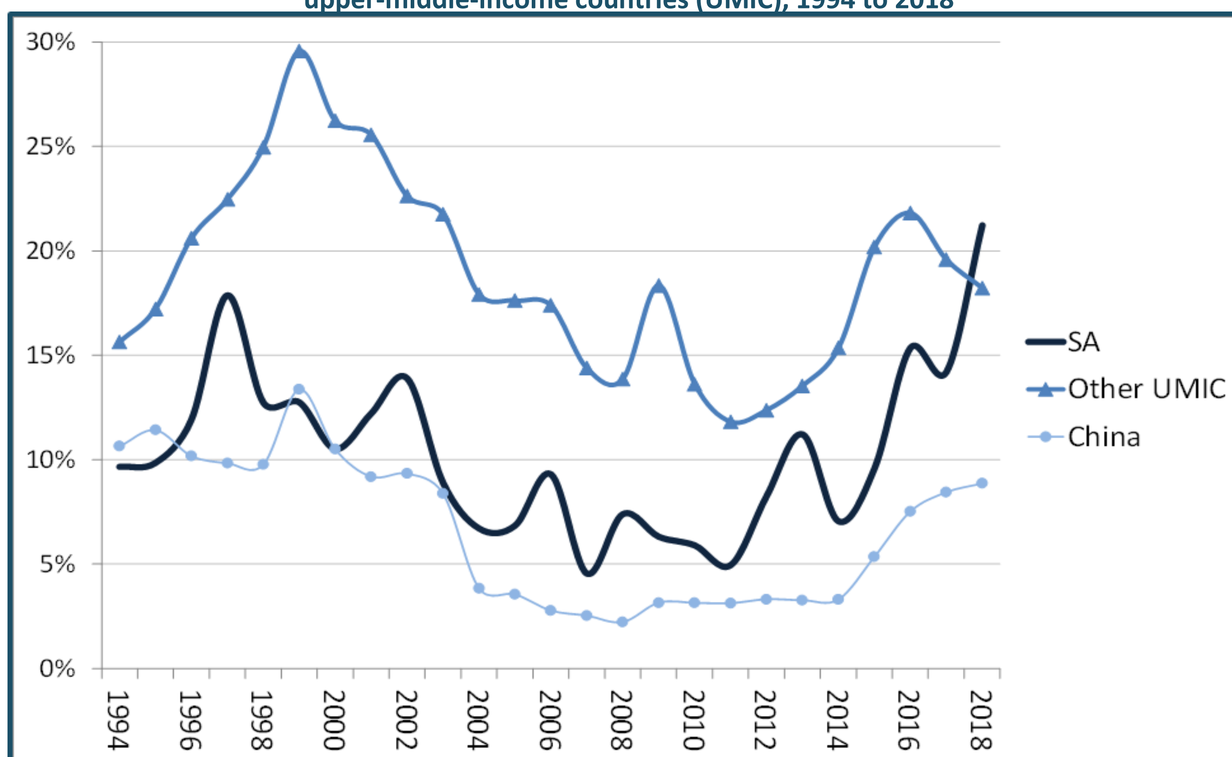
[2]*Calculated from World Bank. World Development Indicators. Interactive dataset. Downloaded from www.worldbank.org in April 2020.*

Graph 3. External public (and publically guaranteed) debt as percentage of gross national income, South Africa, china and other upper-middle-income countries (UMIC), 1994 to 2018



Source: Calculated from World Bank. World Development Indicators. Interactive dataset. Series on GNI and public and private external debt stock in current US dollars. Downloaded from www.worldbank.org in April 2020.

Graph 4. Debt service payments as percentage of export revenues, South Africa, China and other upper-middle-income countries (UMIC), 1994 to 2018



Source: Calculated from World Bank. World Development Indicators. Interactive dataset. Series on total debt service and export revenues in current U.S. dollars. Downloaded from www.worldbank.org in April 2020.

Rising foreign borrowing meant that debt service paid overseas rose from 10% of export revenues in 1994 to over 20% in 2018, despite a decline during the international metals price boom from the early 2000s through 2011. For other upper-middle-income countries excluding China, the debt service ratio was 18% in 1994 and 19% in 2018, although they also saw a decline during the commodity boom (see Graph 4).

Large capital inflows for much of the past 20 years fostered a relatively strong rand, especially when the value of exports was boosted by high mining prices during the commodity boom from 2002 to 2011. Arguably that deterred local production by reducing the rand price of imports and raising the dollar cost of exports. But it enabled rapid growth in the financial sector, which employed around 450 000 people in the late 2010s.

In sum, the main negative impact of the downgrade will be more expensive imports and higher-cost international borrowing for both government and large private companies. In the long run, the associated depreciation could promote local production and economic diversification. The effects of the global crisis as a result of the COVID-19 pandemic, however, already far outweigh the consequences of the downgrade.

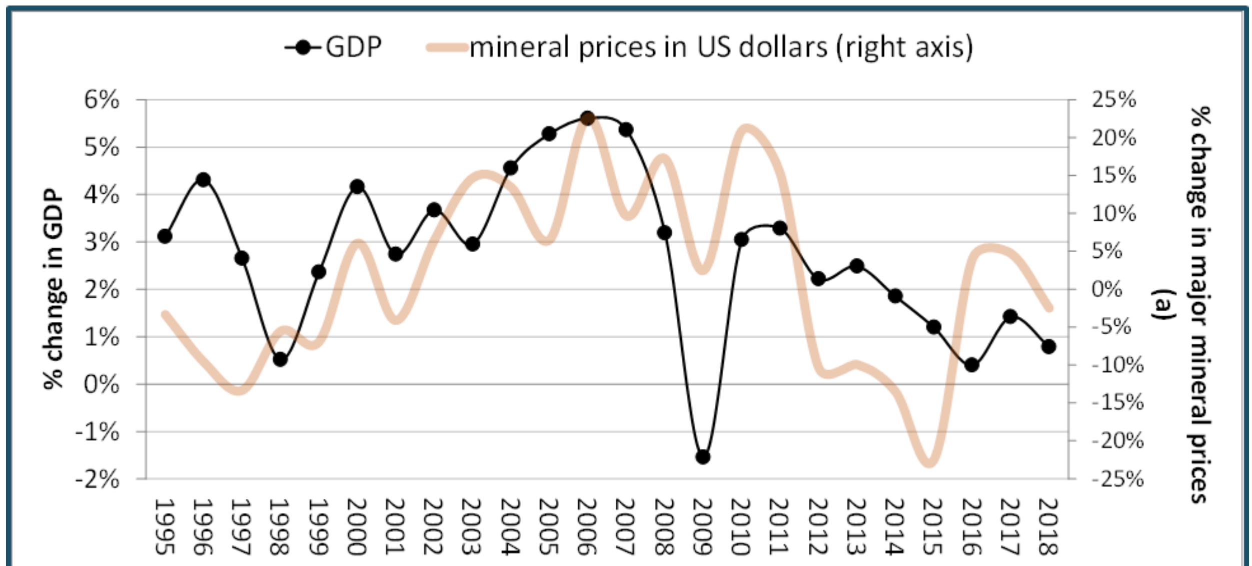
POLICY IMPLICATIONS

The discourse around the downgrade has centred largely on whether government policies could have prevented it. The ratings agencies themselves indicate changes in economic policies and practices that could reverse the downgrade. Like any other policy position, these conditionalities need to be evaluated in terms of relevance to core national concerns as well as their likelihood of success.

Moody's blamed the downgrade on slowing growth in South Africa, which it attributed primarily to the following (see Annexure 1 for the Moody's document).

1. The unreliable electricity supply, which seemed likely to persist for several years.
2. Structural labour market rigidities (undefined, but presumably procedural requirements around dismissals for low productivity or discipline as well as sector-level bargaining and possibly the national minimum wage).
3. Threats to property rights from land reform initiatives.
4. An inexorable rise in government debt as a result of slowing revenues, with cuts to public-sector wages as the only viable solution.
5. Deep inequalities, which in turn fuel policy contestation, making it harder to initiate reforms to the electricity system and labour markets, fully guarantee property rights, and reduce the public-sector wage bill.
6. Particularly high risks from climate change.
7. Institutional erosion under state capture, which both affected traditionally strong governance institutions and led to higher budget outlays on state-owned companies.

Graph 5. Annual percentage change in GDP compared to annual percentage change in international price of exported metals, ores and coat (a), 1995 to 2018



Note: (a) Trade-weighted index of prices for coal, iron ore, platinum and gold. *Source:* For GDP, Statistics South Africa; for prices, Index Mundi/IMF commodity prices.

Moody's said it would consider an upgrade if South Africa met key milestones around improving the electricity supply as well as fiscal reforms to contain expenditure and improve revenues.

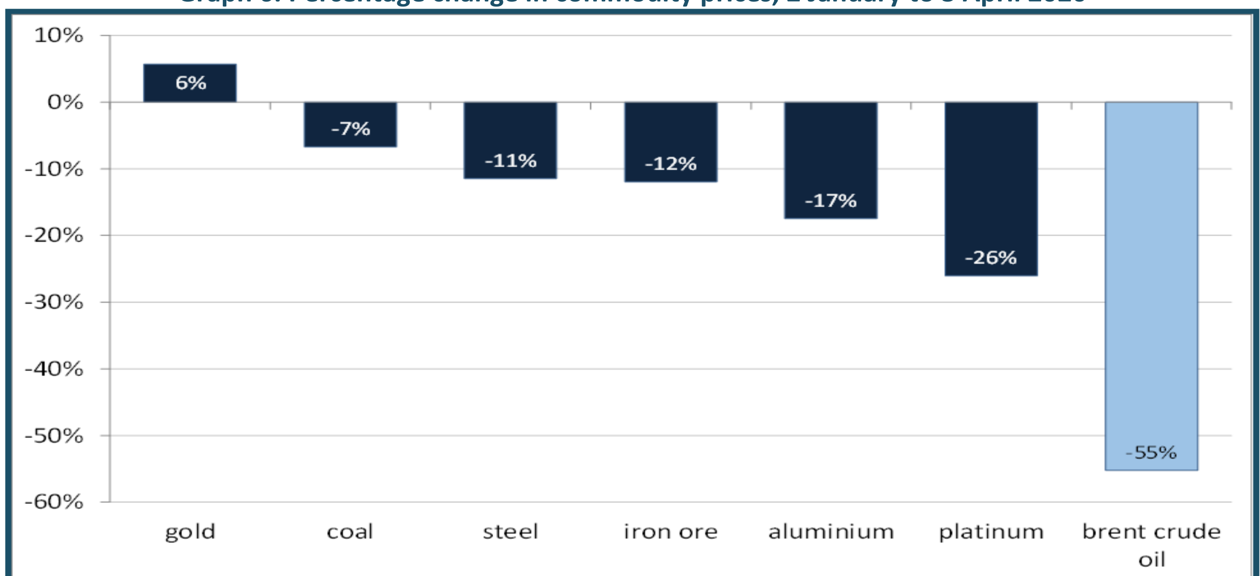
These arguments ignore the most important cause of the economic slowdown, which essentially resulted from the end of the international metals price boom. The boom saw a 30-year high in export prices in 2011. Since over half of South Africa's exports come from the mining value chain (dominated by iron ore, platinum, coal and gold), it effectively brought prosperity through a vast increase in income from exports. From 2011, however, international metals prices fell by between a third and two thirds, depending on the commodity. As Graph 5 shows, South Africa's growth rate effectively paralleled the export prices of its main mining products.

In effect, the end of the global commodity boom in 2011 meant that South Africa's historic growth path, which depended primarily on mining exports, was no longer viable. The global slowdown as a result of the pandemic is further depressing mining prices, which had shown some signs of recovery in 2019.

As Graph 6 shows, the price of platinum in particular plummeted as auto sales internationally dried up, since it is used mainly in catalytic converters. In contrast, gold prices increased, because some investors see it as a safe investment in times of international uncertainty.

Several factors that Moody's notes – especially the malaise around electricity as well as the rising government deficits – derive in large part from the slowdown in the economy from 2011. Most observers

Graph 6. Percentage change in commodity prices, 2 January to 3 April 2020



Source: Calculated from Trading Economics. Commodity prices. Available at www.tradingeconomics.com on 3 April 2020.

agree on the need to fix the electricity system. But Moody's other requirements for a higher rating effectively aim to protect investors from the effects of slowing growth by reducing protection for workers and ending efforts to secure more equitable ownership of assets.

From this standpoint, the ratings agencies' policy demands on South Africa are deeply contradictory. On the one hand, they note that profound inequalities and high joblessness in themselves make it harder to pursue consistent economic strategies and to maintain existing property rights. On the other, their proposals generally centre on cuts to government spending, reducing labour rights, and protecting the existing structures of ownership. All of these solutions would aggravate inequality, rather than alleviating it.

The contradiction between the rating agencies' analysis and their proposals arises in part from their function and mandate. They are not in business to assist South Africans to identify a viable development strategy. Rather, they want policies that will reduce the risk to foreign owners of stocks and bonds. That means, in the short run, they want governments to reduce labour costs and taxes, to minimise any risk of default on debt, and to avoid intervening in property rights. At the same time, they recognise that policies which effectively maintain unusually deep inequalities are not sustainable in the longer run, especially in a democracy. From this standpoint, South Africa has always been in a no-win position: policies that would satisfy foreign investors, as represented by the ratings agencies, will always be politically and socially unsustainable, because they aggravate rather than mitigate the inequalities entrenched under apartheid.

CONCLUSIONS

The economic effects of the recent credit ratings downgrade have been overtaken by the whirlwind of the COVID-19 crisis. The implications for financial investment are trivial compared to the massive outflow of foreign capital that began in early March, as the devastating effects of the pandemic in the US and Europe emerged.

The policy recommendations associated with the downgrade need to be tested in terms of their relevance to national needs and priorities as well as the evidence. Above all, they downplay the main roots of slow growth in recent years – that is, the collapse of export prices and unusually deep inequality. Instead, they focus on proposals that could aggravate social and economic tension and conflict, especially by rolling back worker rights and limiting land reform efforts. These measures would aggravate inequality and policy conflict, which would ultimately harm growth. Moreover, they ignore the core challenge of diversifying away from dependence on commodity exports, which only brings prosperity when global prices are high.

Finally, the downgrade highlights South Africa's unusually heavy dependence on foreign purchases of shares and bonds. That dependency has benefited the financial sector and importers, and has enabled rising foreign borrowing by government. But it has arguably made it harder for local producers to compete both in South Africa and abroad. In the process, it has contributed to continued dependence on mining exports. The result has been continued vulnerability both to international metal prices cycles and to rapid fluctuations in international financial flows.

ANNEXURE A. EXCERPTS FROM MOODY'S RELEASE ON DOWNGRADE

Paris, March 27

RATIONALE FOR THE RATING DOWNGRADE TO Ba1

STRUCTURALLY VERY WEAK GROWTH AND CONSTRAINED CAPACITY TO STIMULATE THE ECONOMY

Unreliable electricity supply, persistent weak business confidence and investment as well as long-standing structural labour market rigidities continue to constrain South Africa's economic growth. As a result, South Africa is entering a period of much lower global growth in an economically vulnerable position. The government's own capacity to limit the economic deterioration, in the current shock and more durably is constrained. Fiscal space is very limited and looser monetary policy will not address underlying structural problems. The unprecedented deterioration in the global economic outlook caused by the rapid spread of the coronavirus outbreak will exacerbate the South Africa's economic and fiscal challenges and will complicate the emergence of effective policy responses.

Progress on structural economic reforms has been very limited. Some initiatives to improve competition and encourage job creation have progressed, but none that constitute a step-change for the economy. Structural issues such as labour market rigidities and uncertainty over property rights generated by the planned land reform remain unaddressed. Moreover, a strategy to stabilize electricity production has been slow to emerge and has yet to prove its effectiveness. Moody's assumes that while power supply will become more reliable, the restoration of full capacity will take some years to complete. As a result, after the immediate sharp downturn, growth will remain very low in the following years.

INEXORABLE RISE IN GOVERNMENT DEBT OVER THE MEDIUM TERM

South Africa's debt burden will rise over the next five years under any plausible economic and fiscal scenario… In this context, and consistent with the recently announced budget, any fiscal consolidation will rest primarily on containing the large and growing public sector wage bill. The government aims to achieve ZAR160 billion

(3% of GDP) in savings over the next three fiscal years by keeping wage growth below inflation. That would mark a material departure from current agreements and past outcomes, and as such is likely to prove challenging to implement. Moody's expects expenditure on wages to exceed budget at least in 2020.

Interest rates are likely to rise above the levels assumed in the budget and nominal growth will be weaker. Moody's estimates that the debt burden will reach 91% of GDP by fiscal 2023, inclusive of the guarantees to state-owned enterprises from 69% at end of fiscal 2019. Even if the government's plans to restrain wage growth were fully implemented, debt-to-GDP would still continue to rise significantly. Similarly, even under a scenario of more effective improvement in tax compliance and falling interest rates from fiscal 2021, government debt would still rise to around 87% by 2023.

RATIONALE FOR THE NEGATIVE OUTLOOK

The negative outlook reflects downside risks around economic growth and fiscal metrics, that could lead to an even more rapid and sizeable increase in the debt burden, further lowering debt affordability and potentially weakening South Africa's access to funding.

Downside risks to growth are both immediate and longer term, relating to heightened uncertainty about the economic impact of the coronavirus pandemic and to the possibility that negative economic sentiment becomes further entrenched as policymakers and stakeholders continue to struggle to reach consensus on the structural reforms that would sustainably stimulate growth and employment. With unemployment at already very high levels (29%), even weaker growth would have significantly negative social implications.

Should these downside risks materialise, South Africa's government debt would stabilise later and at a higher level than currently expected by Moody's. A steeper increase in debt would weaken debt affordability, potentially challenging the government's currently strong access to funding at manageable costs, particularly during periods of acute risk aversion by global investors such as at present. Although South Africa's exposure to global financing conditions is mitigated by its reliance on local currency debt, its weak economic and fiscal fundamentals could exacerbate adverse capital flows.

ENVIRONMENTAL, SOCIAL, GOVERNANCE CONSIDERATIONS

Environmental risk influences Moody's assessment of South Africa's economic resilience. Due to its geographical location, South Africa is subject to frequent climate change-related shocks such as droughts which undermine the agricultural sector's performance and weigh on growth. Set against that, the country's economic diversification and sophisticated agricultural techniques mitigate the impact of environmental considerations on South Africa’s credit profile.

Social considerations are material for South Africa's credit profile and their implications for the economy and public finances are a driver of the rating downgrade. Deep socio-economic inequalities complicate the implementation of reforms that would otherwise unlock the economy's significant potential. They also contribute to tensions and resistance from key stakeholders that ultimately fuel political risk.

Governance considerations are material to South Africa's credit profile. South Africa's ranking under the Worldwide Governance Indicators is stronger than Ba1-rated sovereigns, and the strength of key institutions, in particular the South African Reserve Bank and the Treasury, support the rating. However, the broader erosion in institutional strength induced by the wide-spread corruption of the Zuma administration is an important factor behind the erosion in South Africa's credit profile in recent years. Moreover, the legacy that era has bequeathed of poor governance of state-owned enterprises remains a key drain on fiscal resources.

WHAT COULD CHANGE THE RATING UP

Given the negative outlook a rating upgrade is unlikely in the near future.

Moody's would likely change the rating outlook to stable if the government's medium-term fiscal consolidation were to proceed broadly in line with the rating agency's central expectations, with prospects of a slow but durable pick-up in growth and financing risks remaining low. In this scenario, Moody's would likely see a gradual reduction in South Africa's primary deficit in the next few years, with increasing assurance that government debt will stabilize comfortably below 90% of GDP.

WHAT COULD CHANGE THE RATING DOWN

South Africa's ratings would likely be downgraded if Moody's were to conclude that any combination of very weak growth, failure to reduce the primary deficit, and rising financing costs was likely to cause the debt burden to rise to even higher levels than currently projected with even greater uncertainty regarding its eventual stabilisation, in turn threatening South Africa's access to funding at manageable costs. Such an outcome would speak to weaker institutional policymaking capacity and, over time, a diminution of economic and fiscal strength consistent with lower rating levels.

Important indicators in this regard include the government's ability over the next year or so to contain the impact of global recession on the South African economy and to promote recovery thereafter; to agree and begin to implement the structural reforms that would strengthen the economy. The implementation of the framework for a reliable supply of power to the economy and fiscal reforms to contain expenditure and enhance revenues are important milestones.