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Implications of the "Junk" Credit Rating for The South African Economy

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ABSTRACT:
Credit rating agencies plays a pivotal role in appraising investment grading as well as probabilities of whether or not institutions are in a position to honour their financial obligations. Recently, South Africa has been under constant scrutiny of rating agencies and was subsequently downgraded to sub-investment grade or 'junk status' by one of such agencies. The purpose of this paper is to outline implications of the credit downgrade for the South African government and households. The paper utilised document analysis to answer the research question. It was found that the downgrade is likely to affect the inflation rate, interest rates, management of public finances as well as foreign direct investment negatively. In order to restore the confidence of credit rating agencies in the country, it is recommended that authorities in the country should implement a number of measures including application of sound economic policy, revival of struggling industries, identification sectors such as tourism and export-led manufacturing as well as intensify fiscal consolidation.

Keywords: credit rating agencies, junk status.

1. Introduction

The Credit Rating Agencies (CRA), Standard and Poor's Global (S&P) as well as Fitch have downgraded South Africa's (SA) foreign currency sovereign credit rating to a non-investment grade or what is also referred to as 'junk status' in April 2017. This development by S&P and Fitch is likely to result in the other CRA, namely Moody's to revise South Africa's rating negatively to the detriment of the SA government, private sector as well as households (S&P, 2017; Fitch, 2017).

Reasons advanced by S&P for their decision is due to divisions in the African National Congress (ANC) led government, which resulted in a cabinet (executive) reshuffle, including the removal of the minister as well as the deputy minister of finance. This move, it is argued, created a fiscal policy uncertainty risk. This development, S&P further contended, has also increased the possibility of a setback for economic growth that the country desperately need in order to create jobs. It is further suspected that the said cabinet reshuffle could negatively affect fiscal outcomes. This CRA also postulates that divisions in the SA government and in the ANC are most likely to delay fiscal and structural reforms, as well as erode trust between government and social partners, that is, business leaders and labour representatives. It is also contended that there is an additional risk that the business sector may choose to defer investment decisions which would have otherwise bolstered economic growth. S&P is also of the view that on-going tensions in government and the governing party could negatively affect investor confidence, exchange rate as well as on interest rates (S&P, 2017).

Given the background sketched above, the central question is: what could be the likely implications of South Africa's downgrade to "junk status" on

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government and household? The rest of this paper focuses on literature review, research methodology as well as findings. In additions, the conclusion section of the paper outlines recommendations that for the South African authorities in order to restore the investment credit rating.

2. Literature review

This section focuses on the definition of sovereign credit rating, the construction of global sovereign bond benchmarks, Credit Rating Agencies and credit ratings as well as South Africa's key economic statistical data. These are followed by a discourse about South Africa's credit rating history, a distinction between SA's local currency debt rating and foreign currency debt rating.

2.1 Definition of sovereign credit rating

A sovereign credit rating expresses the risk that a country might be not in a position to meet its financial obligations in relation to repaying interest payments and the principal debt timeously.

Basically, a sovereign credit rating is aimed at providing a relative ranking of a country's overall credit worthiness. Furthermore, respective rating agencies utilise various measures that allow them to gauge a country's social, economic and political position in order to determine the probability of defaulting on repayments (Phillips, 2016).

2.2 Construction of global sovereign bond benchmarks

Global sovereign bond benchmarks are constructed on the basis of using the credit quality of the local component (rand) of debt issued. There are three requirements that a country, in this case South Africa, must comply with. First, the country must have outstanding debt with a market capitalisation of US$50 billion. It must be rated investment grade by two ratings agencies. Finally, the country must have open markets easily that are accessible by foreign investors. The inclusion of a country in these indices is based solely on local-denominated currency ratings (Mothata, 2017).

2.3 Credit Rating Agencies and credit ratings

The primary role of credit rating agencies (CRA) especially in relation to capital markets is to appraise the comparative credit risk of specific debt securities or structured finance instruments and borrowing entities (also called issuers of debt). CRAs are also charged with the responsibility of ranking the creditworthiness of governments, including banks as well as state owned enterprises and their securities (http://www.spratings.com/en_US/understanding-ratings). South Africa's credit rating is appraised by the three major CRA, that is, Standard and Poor's Global, Moody's as well Fitch.

Credit ratings are intended to provide opinions about credit risk. For S&P, the ratings express their opinion about the ability and willingness of issuers such as companies, cities or government to meet their financial obligations in full and on time. The ratings can also articulate the credit quality of an individual debt issue, such as a company or municipal bond, and the relative likelihood that the issue may default (http://www.spratings.com/en_US/understanding-ratings).

Assessments by credit rating agencies should be utilised with caution because they are not necessarily absolute measure of default probability. In view of the fact that there are future events and developments that cannot be foreseen, the assignment of credit ratings is not an exact science. It should be noted that ratings are

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not intended as guarantees of credit quality or as exact measures of the probability that a particular issuer or debt issue will default (http://www.spratings.com/en_US/understanding-ratings).

Issue ratings are an assessment of default risk, but may incorporate an appraisal of relative seniority or ultimate recovery in the event of default. Junior obligations are typically rated lower than senior obligations, to reflect the lower priority in bankruptcy, as noted above. (Such differentiation may apply when an entity has both senior and subordinated obligations, secured and unsecured obligations, or operating company and holding company obligations). Table 1 illustrates categories and respective definitions of long-term credit ratings applied by S&P Global (http://www.spratings.com/en_US/understanding-ratings).

Table 1: Categories and definitions of Long-Term Credit Ratings

Category	Definition
AAA	An obligation rated 'AAA' has the highest rating assigned by S&P Global Ratings. The obligor's capacity to meet its financial commitment on the obligation is extremely strong.
AA	An obligation rated 'AA' differs from the highest-rated obligations only to a small degree. The obligor's capacity to meet its financial commitment on the obligation is very strong.
A	An obligation rated 'A' is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligations in higher-rated categories. However, the obligor's capacity to meet its financial commitment on the obligation is still strong.
BBB	An obligation rated 'BBB' exhibits adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation.
BB; B; CCC; CC; and C	Obligations rated 'BB', 'B', 'CCC', 'CC', and 'C' are regarded as having significant speculative characteristics. 'BB' indicates the least degree of speculation and 'C' the highest. While such obligations will likely have some quality and protective characteristics, these may be outweighed by large uncertainties or major exposures to adverse conditions.
BB	An obligation rated 'BB' is less vulnerable to nonpayment than other speculative issues. However, it faces major ongoing uncertainties or exposure to adverse business, financial, or economic conditions which could lead to the obligor's inadequate capacity to meet its financial commitment on the obligation.
B	An obligation rated 'B' is more vulnerable to nonpayment than obligations rated 'BB', but the obligor currently has the capacity to meet its financial commitment on the obligation. Adverse business, financial, or economic conditions will likely impair the obligor's capacity or willingness to meet its financial commitment on the obligation.
CCC	An obligation rated 'CCC' is currently vulnerable to nonpayment, and is dependent upon favorable business, financial, and economic conditions for the obligor to meet its financial

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	commitment on the obligation. In the event of adverse business, financial, or economic conditions, the obligor is not likely to have the capacity to meet its financial commitment on the obligation.
CC	An obligation rated 'CC' is currently highly vulnerable to nonpayment. The 'CC' rating is used when a default has not yet occurred, but S&P Global Ratings expects default to be a virtual certainty, regardless of the anticipated time to default.
C	An obligation rated 'C' is currently highly vulnerable to nonpayment, and the obligation is expected to have lower relative seniority or lower ultimate recovery compared to obligations that are rated higher.
D	An obligation rated 'D' is in default or in breach of an imputed promise. For non-hybrid capital instruments, the 'D' rating category is used when payments on an obligation are not made on the date due, unless S&P Global Ratings believes that such payments will be made within five business days in the absence of a stated grace period or within the earlier of the stated grace period or 30 calendar days. The 'D' rating also will be used upon the filing of a bankruptcy petition or the taking of similar action and where default on an obligation is a virtual certainty, for example due to automatic stay provisions. An obligation's rating is lowered to 'D' if it is subject to a distressed exchange offer.
NR	This indicates that no rating has been requested, or that there is insufficient information on which to base a rating, or that S&P Global Ratings does not rate a particular obligation as a matter of policy.
***The ratings from 'AA' to 'CCC' may be modified by the addition of a plus (+) or minus (-) sign to show relative standing within the major rating categories.**	

Source: S&P Global Rating: http://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352)

Table 1 illustrates that S&P uses 15 grading categories to assess the credit rating of countries, state owned enterprises as well as corporate. An obligation graded as ‘AAA’ represents the highest rating assigned by S&P Global Ratings. It implies that the capacity of the obligator to its financial commitments to the obligation is “extremely strong”. However, a BBB grading and below are less favourable because they denote “adverse economic conditions’ or signify ‘changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation http://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352)”.

2.4 South Africa’s key statistical data

The Republic of South Africa is one of the leading and most developed economies in Africa. Up until 1994 the country was governed by a white minority which enforced a separation of races with its policy called *apartheid* (www.bbc.com/news/world-africa-14094760). Table 2 below illustrates key statistical data in relation to South Africa.

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Table 2: Key economic statistical data

Indicator	Value
Population size	55,91 million (Based on 2016 Mid-year estimate)
Gross Domestic Product (GDP)	0,3% quarter on quarter (as at 2016 Quarter 4)
Unemployment	26,5% (as at 2016 Quarter 4)
Gross Domestic Product (GDP)	0,3% quarter on quarter (as at 2016 Quarter 4)
Consumer Price Index (CPI)	6,3% year on year (as at February 2017)
Producer Price Index (PPI)	5,6% year on year (as at February 2017)

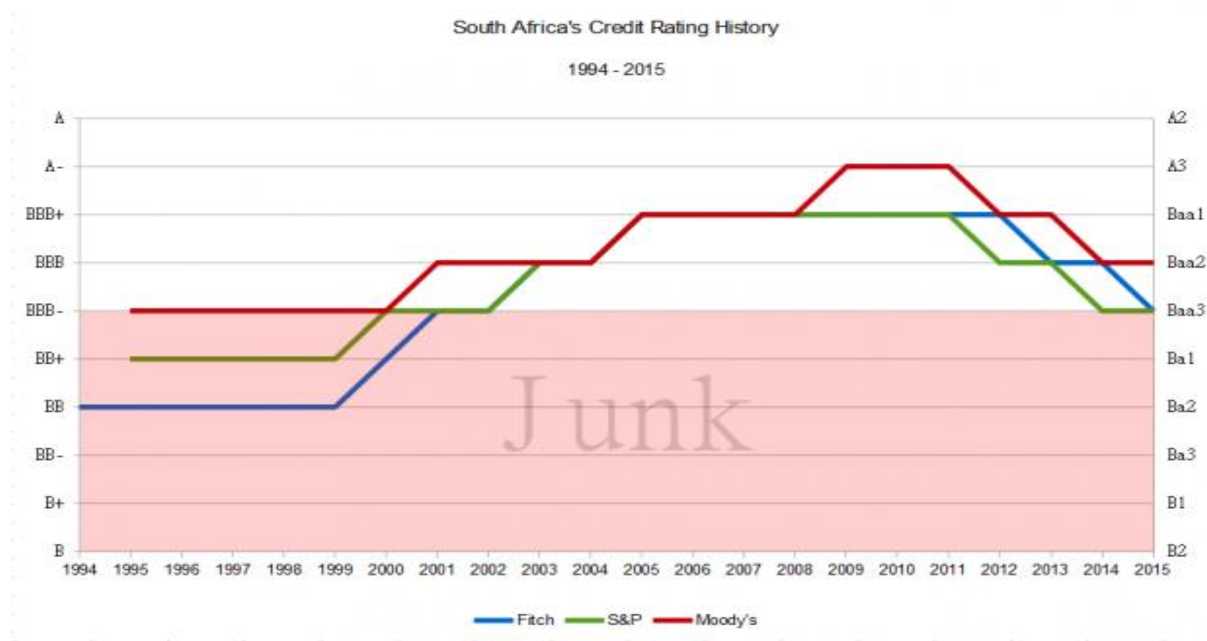
Source: Statistics South Africa - http://www.statssa.gov.za/)

It is evident from the data shown it Table 2 that South Africa's economic growth of less than 1% (0,3%) at the end of 2016 is insufficient to create jobs in the country and thus make a significant dent of the high unemployment standing at 26,5% as at quarter 4 of 2016. The South African National Planning Commission (2011) has identified unemployment as one of the key challenges confronting South Africa. In addition, poverty and inequality are among fundamental challenges confronting the country (MG: https://mg.co.za/article/2011-09-16-poverty-and-inequality-in-south-africa , 2011.

2.5 South Africa's credit rating history

The credit rating history of South Africa is illustrated in figure 1.

Figure 1: South Africa's credit rating history: 1994 - 2015



Source: https://businesstech.co.za/news/business/106461/what-junk-status-means-for-south-africa/

Prior to the April 2017 downgrading to 'junk status', South Africa was rated positively by the three Credit Rating Agencies (i.e. Fitch, S&P and Moody's), except for the period 1994 to 2000. During the period where in South were rated positively (2000 - 2015), Moody's tended to rate

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the country in a more favourable light as compared to the other two rating agencies.

2.6 Distinction between SA's local currency debt and foreign currency debt rating

Foreign currency denominated debt is characterised as debt that is issued in a currency other than the sovereign's own currency (i.e. South African issued government bonds in US Dollars, Japanese Yen or Euros), while local currency debt is issued in the South African Rand (Phillips, 2016). Table 3 below displays SA's local and foreign currency debt ratings by the respective rating agencies before the April 2017 downgrading to sub-investment rating by S&P and Fitch.

Table 3: SA's sovereign credit rating before the 2017 downgrade to 'junk status'

SOVERIGN CREDIT RATING				
Moody's	**Standard & Poor's**	**Fitch**	**Credit rating**	
Aaa	AAA	AAA	Highest quality	Investment Grade
Aa1	AA+	AA+	High quality	Investment grade
Aa2	AA	AA		
Aa3	AA-	AA-		
A1	A+	A+	Strong capacity	Investment grade
A2	A	A		
A3	A-	A-		
Baa1	BBB+	BBB+	Adequate payment capacity	Investment grade
Baa2	BBB	BBB		
Baa3	**BBB-**	**BBB-**		
Ba1	BB+	BB+	Likely to full obligations, Ongoing uncertainty	Sub-investment grade (Junk status)
Ba2	BB	BB		
Ba3	BB-	BB-		
B1	B+	B+	High risk to obligations	Sub-investment grade (Junk status)
B2	B	B		
B3	B-	B-		

Source: Barclays Emerging Market Research, 2017

As illustrated in Table 3, Moody's has one rating (Baa2) which applies to both the local and foreign currency denominated debt, while Standard and Poor's and Fitch distinguishes between SA's foreign and local currency debt ratings (Phillips, 2016).

Table 3: South Africa's local and foreign denominated debt rating

	MOODY'S	STANDARD & POOR'S		FITCH	
		Foreign currency	**Local currency**	**Foreign currency**	**Local currency**
Ratings	**Baa2**	**BBB-**	**BBB+**	**BBB-**	**BBB+**

Source: Barclays Emerging Market Research, 2017

Moody's rating for South Africa is two notches above 'junk status', while Standard and Poor's Global rating for foreign currency was one notch above 'junk status', but its rating for SA's local

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currency is still three notches above 'junk status'. On the other hand, Fitch's rating of the country's foreign currency was two notches above 'junk status', while the rating for local currency is still three notches above 'junk status' (Phillips, 2016).

3. Research Methodology

The paper relied primarily on document analysis to answer the research question. Document analysis is a qualitative research method in which documents are interpreted by a researcher in order to give meaning to a topic of interest, in this case, implications of a credit down grade for the South African economy. This process incorporated coding content into themes, in the same way that transcripts of focus group or interview transcripts are analyzed
http://studentresearch.ucsd.edu/_files/assessment/Assessment-Methods.pdf).
Documents that were analyses included journal articles, official statements from public institutions such as the South African Reserve Bank as well as credit rating agencies, newspapers articles and market updates from investment houses.

4. Findings

4.1 Background

Commentators have pondered about ramifications of a possible credit downgrade to "junk status" for South Africa as far back March 2016. For instance, Donnely (2016) predicted that a credit downgrade could result in a further depreciation of the rand, higher inflation and interest rates to the detriment of everyone. This confirms the argument that a downgrade to junk is "zero good and all bad" for the country. Now that the inevitable has happened, with S&P Global revising SA's credit rating to "junk status", it seems there is no general consensus about the implications of this unfavorable decision especially for households and the government in South Africa. Some economists argue that although international markets are anxious about what a credit downgrade might mean for the Republic, some economists are of the view that the majority citizens were unlikely to feel an immediate impact (Malikane cited in Gamon & Mabuza, 2017; Gamon & Mabuza, 2017). The next section explores the possible implications of the credit downgrade on SA's households.

4.2 Possible implications of the "junk" credit rating on the SA's economy

This section will focus on the probable effect on the value of the rand, interest rates, Foreign Direct Investment and credit rating of banks as well as the main state owned enterprises, including households with capital in investments and assets and public finance management. This is followed by Lessons learned from other emerging market countries and way forward for SA.

4.2.1 Effect on the value of the rand

The announcement by S&P to downgrade SA's foreign credit rating immediately caused the rand to depreciate by between 10 – 15% against the US Dollar. The rand's loss of value went below what is referred to as "a critical resistance level". This might make it difficult for the local currency to avoid further depreciation f over time (du Toit, 2017; Malikane cited in Gamon & Mabuza, 2017). The rand depreciation is thus likely to increase the inflation rate, culminating in an increase in prices of even basic consumer goods such as food and fuel.

4.2.2 Impact on interest rates

Rand depreciation might leads to higher inflation, which might in turn trigger an interest rate kike from the South African Monetary Policy

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authorities, that is, the South African Reserve Bank or the SARB (van Papendorp & Packirisamy, 2016). The downgrade of South Africa to junk status will make it difficult for the Monetary Policy Committee of the SARB to reduce interest rates (SARB, 2017) or even result in an increase in interest rates in the longer term.

In other words, South Africa's downgrade to 'junk' status is likely to increase in the 'risk premium', that is, lenders will increase interest rates because of a perceived greater risk in default, thus curtailing the household expenditure. An increase in interest rates will further reduce disposable incomes of consumers who must repay their home loans, motor finance, credit cards, bank overdraft as well as personal loans. In addition, the ratings downgrade is likely to lower access to credit for households (Malikane cited in Gamon & Mabuza, 2017). The latter development might have a negative effect on job creation in the country due to the high cost of borrowing for investment in plant, machinery and inventory firms.

4.2.3. Effect on Foreign Direct Investment

A more serious implication of South Africa's downgrade to 'junk status' is that foreign investors will be less inclined to invest in South Africa. This might further have a negative on economic growth as well as the capacity of the economy to create more jobs (Phillips, 2016).

4.2.4 Effect on credit rating of banks and main state owned enterprises

Phillips (2016) predicted that those institutions that offer credit in South Africa such as banks will also experience a credit rating down grade similar to that of the country. To that effect, S&P Global has similarly downgraded SA's main banks Such as Barclays Africa, First Rand and others to 'junk status'. The same is likely to happen to state owned enterprise such as Eskom, electricity supply entity in South Africa (Phillips, 2016).

4.2.5 Effect households with capital in investments and assets

It is argued that South Africa's down grade to 'junk status' is likely to affect households with capital in terms of investments and assets negatively because of a decline in their net worth, although it is argued that only a minority will be affected because majority of households in the country do not have financial assets (Phillips, 2016).

4.2.6 Impact on public finance management

The downgrade to 'junk' status implies that certain investment funds are no longer allowed to invest in the South African bond market. This implies that it will not only be difficult for the government to raise funds to finance the budget short fall, but it will be relatively more expensive to service the public debt. This might lead to review of the fiscal policy to the detriment of expenditure in social services or increase in both direct as well as indirect taxes (van Papendorp & Packirisamy, 2016).

4.3 Way forward: All is not lost for South Africa

It is evident that the decision by S&P Global and Fitch to downgrade South Africa to "junk" investment rating has a negative outcome for the country. However, it should be mentioned that the rating does not impact the eligibility of the country in global bond indices as yet. South Africa is included in a few indices (see the figure above), each with a different weighting. A widely-used global bond benchmark is the Citigroup World Government Bond Index (WGBI). The

WGBI has three stipulated exit requirements for a country, that is,

- When the market capitalisation of outstanding debt falls below half entry level (in other words US$25 billion) for three consecutive months,
- When a country gets downgraded into non-investment grade by both Moody's and S&P on its long-term domestic credit and
- When authorities deliberately introduce policies that materially change the ability of investors to replicate the returns of that country's portion of the index (Mothata, 2017).

The good news is that South Africa remains safe within global bond benchmarks as the three exit requirements are not yet triggered yet. All rating agencies still have South African credit quality rated in investment grade. However, increased trading volumes and further ratings downgrades could have a material impact on South Africa's ability to raise funds as well as, to a significant degree, the flow of capital into South African bonds (Mothata, 2017).

According to the *Financial Times*, South African sovereign bonds, even before the cabinet reshuffle unfolded, saw a substantial increase in trade volumes in the European markets. South Africa's benchmark 10-year government bond had become the fourth most heavily traded sovereign bond in Europe according to Trax. March 2017 was a record month for trading volume in South African bonds at (€15 billion, which was regarded as the largest figure on record. This was 52% higher than the average monthly volume since July 2013 (Financial Times, April 2017; Mothata, 2017).

4.4 Lessons learned from other emerging market countries

One of the fundamental lessons learned from the global financial crisis in 2008 is that the judgment of credit rating agencies can have a huge impact on macroeconomic outcomes (Gärtner, Griesbach & Jung, 2011). A study of emerging market countries downgraded to non-investment grade suggests the impact of junk status depends deeply on how fiscal powers-that-be responds after such a decision. In instances where there is agility in policy response, including making hard and frugal decisions which involves opening up the economy further, as observed in South Korea in 1998, it took 24 months revert to investment grade. In contrast, in the case of countries characterised by complex internal political structures as well as lethargic fiscal policy response, the recovery process could take as much 12 as it was the case with Colombia (Mothata, 2017).

5. Conclusion

It should be accepted from the onset that a process to restore South Africa's positive rating will not happen overnight. It took between two to twelve years for countries that were previously downgraded to junk investment grade to recover. These countries include Brazil and Russia (fellow "BRICS" countries) as well as Colombia. That been said, in order to ensure that SA regains a positive credit rating, the government together with social partners should implement a number of measures. These should include application of sound economic policy, which must incorporate reducing the budget deficit and other budget reforms. Secondly, industries regarded to be currently "on their backs" should be revived by finding concrete investment projects that would catalyse their recovery. These industries include mining, construction and agriculture. Thirdly, sectors such as tourism and export-led manufacturing with a high growth potential must be fully exploited. Fourthly, legislative

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impediments to investment must be fixed as a matter of urgency. This must include improving and finalising amendments to the Mineral and Petroleum Resources Development Act as well as addressing legislation that cause uncertainty over the protection of property rights. Finally, the South African government must intensify the process of fiscal consolidation. This will require agreement across government about what needs to be achieved as well as exceptional leadership particularly between the presidency and key ministries such as finance and public enterprises, among others.

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