Checkmate: South Africa's credit rating downgraded to "junk status"

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Without Prejudice

In a catastrophic move for South Africa, credit rating agency Standard and Poor (S&P) downgraded South Africa's credit rating to "junk" status.

On 3 April, S&P cut South Africa's credit rating by one notch to BB+, which is its highest non-investment grade mark (or "junk" status), and also assigned Africa's most industrialised economy a negative outlook. The decision follows President Jacob Zuma's major Cabinet reshuffle on 31 March, when several ministers, including Finance Minister Pravin Gordhan and his deputy, Mcebisi Jonas, were axed.

Four days later, on 7 April, Fitch followed suit and subsequently also downgraded South Africa to "junk" status.

A downgrade to "junk" status means that a country is perceived as a defaulting risk because it can't pay back what it has borrowed. 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.

S&P decided that the economic crisis Zuma plunged the country into with his midnight cabinet reshuffle was too severe to wait until its next scheduled review of South Africa's sovereign rating in June. It explained its decision, "[t]he downgrade reflects our view that the divisions in the ANC-led government that have led to changes in the executive leadership, including the finance minister, have put policy continuity at risk". It also stated that the cabinet reshuffle has put fiscal and growth outcomes at risk.

The credit rating agencies

Credit ratings agencies have played a crucial role in assessing the ability of governments, financial institutions and corporations to pay up on time, and in full. These institutions have a major influence on investor perceptions of credit risk. International rating agencies S&P, Moody's and Fitch, have been at the top of more than 70 agencies around the world, with a claim on 90% of the global market.

Credit ratings are important as they are seen as a confidence barometer in a country's economy. Scoring national governments on how credit-worthy they are helps determine the interest rates countries pay to borrow money.

Moody's has also put out statements with dire warnings about a downgrade to South Africa's credit rating. Within hours of S&P's announcement, Moody's placed South African government debt on a review for a possible downgrade: "[c]hanges within a government do not generally signal material changes in a country's credit profile. Here, however, the timing and scope of the reshuffle raises questions over the signal they send regarding the prospects for ongoing reforms, the underlying strength of South Africa's institutional framework, and the fragile recovery in the country's economic and fiscal position." It also indicated that recent events signalled a deterioration in the effectiveness of government and in the credibility of its policy-making.

Fitch also stated that it was changing its outlook on South Africa from stable to negative, as "[p]olitical risks to standards of governance and policy-making have increased".

The ground effects which the downgrade will have on the day-to-day lives of South Africans

The rand

The rand will continue to weaken.

Reuters has reported that as much as US$10 billion dollars could leave the country. As more people sell rands and buy other currencies instead, the value of the rand drops.

Petrol and food prices

A weaker rand means that inflation will rise. Petrol prices and therefore food prices will also rise.

The raw ingredient of petrol – oil – is bought in dollars, so when the rand weakens, oil prices rise and so does the petrol price. These higher transport costs affect the price of everything moved by trucks – from food to imported goods and anything you buy at a shop.

Food is traded on international markets in dollars. The prices of rice, maize, sunflower oil, wheat and sugar are set in dollars. A weaker rand means we pay more for food, especially if it is imported. Households will therefore suffer.

Interest rates

Interest rates are likely to increase, and South Africans will, therefore, have to pay more to repay their debt. For example, monthly car payments and home loan payments will increase.

The South African Reserve Bank often hikes the repo rate in response to higher inflation and as a measure to dampen inflationary pressures. This leads to banks also increasing their interest rates. As the economy weakens, lenders will increase interest rates because of a perceived greater risk in default. S&P has indicated that ongoing tensions and the potential for further event risk could weigh on investor confidence and exchange rates, and drive increases in real interest rates.

Financial institutions will need to hold more money in reserve, which will make it more difficult to obtain credit, and credit that is granted will come at a higher cost.

An increase in interest rates means the general cost of borrowing goes up including on short-term loans, car and home loans and credit card repayments.

Debt has just become more expensive. A recent World Bank index has shown that South Africa's consumers are amongst the most indebted in the world and there is a very real possibility that banks may foreclose on more homes and repossess more cars.

Taxes

Taxes are likely to increase further – over and above the marginal tax rate increases announced by the former finance minister in his recent budget speech.

Government borrows almost monthly to pay its bills, as it spends more than it earns. Junk status ultimately means it will pay much more to borrow money and will be faced with two choices: to cut spending or increase taxes to cover the extra costs spent on debt. Government's track record suggests that it does not have the ability to cut spending, and hence the only available option will be to further increase taxes.

Government spending

The cost of interest on government debt was ZAR128 billion or 3.2% of GDP from April 2015 to March 2016; S&P expects this to rise to 4.25%. This means that just over 4% of GDP would go to interest repayments, before paying off the actual debt.

The consequence of higher interest on borrowings means there is less money for government spending on basic and critical services such as education, housing, health, social grants, sanitation, infrastructure as well as the capital of the actual debt, which could incite more of the protests that have already rocked the country.

Since many institutions, such as banks, are not allowed to invest in junk status debt, government will be forced to borrow from whose willing to invest in higher risk debt. This is more expensive.

Investors and the investments of South Africans

Recent tax increases targeted, and likely future tax increases will target corporations and those classified as wealthy and middle class.

These corporations and individuals will be less able and increasingly less willing to invest their money in South Africa. The downgrade will lead to a steep erosion of already poor levels of investor confidence, and perceived high risk will scare away future foreign investment. International investors will pull their money out of South Africa. The immediate effect is a drop in the value of equities and bonds, while the rand depreciates. The result – a decrease in the value of all South Africans' savings, investments and pension funds. Domestic investments, over time, will not grow because the prospects for prosperity have been dimmed by the downgrade.

Households with capital in South African investments and assets will be most affected, as their net worth will decrease.

Furthermore, many local and foreign investment funds that invest pensions or savings into debt are not allowed to do so where a country has junk status. Investment funds will, therefore, sell their debt, as they are mandated to place their money in investment-grade jurisdictions only.

The consequences of a decrease in foreign investment – no new factories, no new businesses, no new initiatives, no new jobs, and no investment which is needed to address South Africa's challenges of unemployment, poverty and inequality.

S&P has stated that businesses may now choose to withhold investment decisions that would otherwise have supported economic growth.

Business

As the economy deteriorates further, smaller businesses are most likely to take a knock, and it is foreseen that more companies will go into business rescue or liquidation.

Employment

Diminishing economic growth will make employment harder to find as the job market will either shrink or remain static.

South Africans currently employed are also at risk, as certain sectors might experience retrenchments.

It is foreseen than many South Africans may emigrate to pursue their goals elsewhere. The loss of some of South Africa's best talent and skills will further inhibit economic growth.

The impact of the downgrade on Africa in general

The political instability triggered by the extensive cabinet reshuffle is likely to have a domino effect into Africa.

South Africa's economy is the second largest in Africa, and accounts for 35% of Africa's GDP. Any weakening of the economy will, therefore, have a direct impact on the rest of Africa.

South Africa's principal trading partners include many of the other African countries. South African exports to the rest of Africa are predominantly of value-added goods. The country's investment stock in Africa has increased over the years and amounts to approximately 20% of its total outward foreign direct investment.

Leading economist Dr Azar Jammine stated that one of the opportunities created by the current economic situation is the export market, because inflation has not picked up sharply and, therefore, costs are rising at a slower pace. It is hoped, therefore, that the downgrade to junk status will not be only doom and gloom. South Africa remains in the grip of a damaging political crisis. S&P has indicated that the downgrade to junk status means that economic growth and fiscal outcomes will suffer. The poor will bear the brunt of the downgrade, as will young people.

South Africans will need to reduce short-term debt as soon as possible and consolidate long-term debt by increasing repayment instalments to reduce outstanding capital debt faster. And they will need to save.

Research reveals that on average, it takes approximately seven to eight years for a country to recover from a downgrade. The downgrade is a slow poison to South Africa, and every South African will feel the effects for years to come.

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