



South African Reserve Bank

**Keynote address by Lesetja Kganyago,
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Sovereign rating downgrades and their impact on the poor

Good evening, ladies and gentlemen.

The sovereign ratings of South Africa, which are the key theme of my speech this evening, have been a prominent concern for policymakers and investors alike in recent years, and will again feature heavily in policy discussions as the year-end approaches. Following the gradual and regular improvement in our country's sovereign ratings from the advent of democracy to the mid-2000s, which saw South Africa regain investment-grade status, South Africa's credit standing has again deteriorated in recent years.

Both Standard & Poor's and Moody's rating agencies started downgrading South Africa in 2012; this process culminated in the loss of investment-grade status (for foreign-currency debt) in 2016 with two of the three major rating agencies. Further reviews of South Africa's ratings are due before year-end. Our growth and fiscal performance, in particular, are therefore under a high degree of international scrutiny at present.

The financial market and policy implications of rating downgrades are well documented, ranging from difficulties in getting non-resident investors to finance the current account deficit, through a greater volatility of financial markets, to higher costs of borrowing for the sovereign. What many people are less familiar with are the implications for the public at large, for incomes and inequality, and in particular for the lower-income segment of the population. These are the points that I would like to discuss this evening.

The general public, in particular the poorer households, may wonder how a rating downgrade can directly affect their daily lives. After all, poor people do not borrow overseas; they do not run businesses that are dependent on financing by foreign investors; they rarely travel overseas; they do not directly hold shares in listed companies.

Some voices, indeed, may go further and say that South Africa's government should not pay excessive attention to the decisions of foreign-based rating agencies. These voices may argue that the decisions of rating agencies mostly affect wealthy individuals and have limited bearings on the economic well-being of the poorer majority. Let me explain why such thoughts are misguided.

Irrespective of its *direct* implications, a sovereign rating downgrade does have *indirect* impacts on all the citizens of the country. These can be felt harder by the poorer households who, unlike the wealthier ones, do not have the possibility of 'hedging themselves' from the consequences of a downgrade by diversifying their assets. There are five major channels through which the recent rating downgrades can undermine the well-being of poorer households, which I will discuss more in detail.

The ratings of a listed entity (be it a government or a corporation) are meant to reflect its 'credit quality'. Hence, they are used by international investors to gauge the risk of buying the bonds issued by that entity. In theory, therefore, these investors will – subsequent to a downgrade – require a premium in the form of a higher interest rate, or they will shun these bonds altogether. South Africa requires foreign investors to finance its external deficit (as its imports regularly exceed its exports). A rating downgrade therefore means that financial markets will move to a new equilibrium where the interest rates on bonds are higher and the exchange rate of the rand is weaker than before the downgrade.

Obviously, the recent empirical evidence is clouded by the fact that many other factors, bar sovereign ratings, influence the price of South African financial assets. Nonetheless, a standard measure of sovereign credit risk for South Africa, namely the credit default swap (CDS) spread, has underperformed compared to its emerging-market peers in recent years, and is now trading at similar levels to non-investment-grade countries. This is clear evidence that investors are requiring a higher risk premium, if only in relative terms, on South African government debt. The increase in the yield on inflation-linked bonds issued by National Treasury, over the past two to three years, is another such indication. Even after being fully protected against inflation, bond investors require a higher return – even as global economic factors have continued to depress risk-free, real interest rates all over the world.

These higher yields on South African bonds will, over time, negatively affect the poor. As the South African government faces a higher cost of borrowing, it will have to devote a larger share of its (finite) resources to

servicing debt. Already, estimates by National Treasury indicate that government debt-servicing costs are expected to represent 10.4% of total budget spending (and 3.5% of GDP¹) in 2017/18, up from a low of 7.0% in 2009/10. This stands in contrast to the years prior to the global financial crisis, when the improvement to South Africa's credit rating coincided with a gradual decline in the share of public spending devoted to servicing debt.

In turn, when debt-servicing costs rise faster than the overall budget, the amount of money available for other missions – especially those of utmost importance to the poor, like public health, education, infrastructure, and social services – is reduced. Across the world, countries with the lowest creditworthiness and with the most difficult access to international market financing are generally those with the poorest Human Development Indices. To a large extent, poor households 'pay' for the low credit quality of their sovereign.

Some may argue that, faced with higher debt-servicing costs, there are policy alternatives to curbing redistributive government expenditure, such as increasing public borrowing or raising taxes on higher-income households. However, these alternatives are probably not sustainable in the long run. Simply adding to borrowing would most likely, over time, prompt further downgrades, raise interest rates, and threaten a financial crisis. From 26% of GDP just before the global financial crisis, South Africa's debt-to-GDP ratio is expected to rise to 52% in the current financial year, even without including contingent liabilities. (This is, effectively, a doubling of the ratio in less than 10 years.) From what was

¹ gross domestic product

a relatively low level by emerging-market standards in the 2000s, South Africa's debt-to-GDP ratio has moved to a relatively high position, which could – if continued – reduce our country's relative attractiveness to global investors.

Equally, raising taxes on higher-income households and corporations, in a country where the tax system is already fairly progressive (and the tax burden, at least by emerging-market standards, relatively high), could undermine the already anaemic pace of economic growth or trigger capital outflows. For the state to effectively help the poor, it needs maximum fiscal space, and that means (among other things) well-managed public finances and sustainable debt burdens. This also has key repercussions for monetary policy's ability to best contribute to sustainable long-term economic growth. In the event that public finances keep deteriorating, a country can experience 'fiscal dominance' – when the central bank's interest rate policy is primarily dictated by the need to ensure adequate financing of the budget deficit at the expense of other, real, economic considerations. It is easy to see how this can be a suboptimal outcome from the point of view of economic development.

Fortunately, these difficult trade-offs have to be made by duly elected representatives of the people of South Africa. As the South African Reserve Bank, we only look at what the implications of these are for monetary policy.

Furthermore, a rating downgrade will not only affect the price of government debt; it will also affect what is paid by all the other bond issuers in the country – raising, for instance, the cost of issuing and servicing debt for banks and state-owned utilities. To maintain profitability,

it is likely that banks will pass on these higher costs to their customers, in the form of higher rates on loans or higher bank fees or lower interest rates paid on deposits. In fact, higher funding costs for banks may be one of the reasons why the spreads between bank lending rates and the repurchase rate as well as deposit rates have widened since the global financial crisis. With many low-income households relying on cash loans for meeting their subsistence needs (often at already-high rates) or using bank deposits as a major form of savings, one can easily see how higher borrowing costs of banks can penalise them. Equally, if a state-owned utility like Eskom is forced to pay higher interest rates on its debt, such costs are likely to ultimately be passed through to their customers – in the form of higher electricity tariffs, including for poorer households.

Separately, South Africa's domestic savings are insufficient to meet its investment needs. Offshore borrowing is therefore required to fund growth and development. So, any downgrade in sovereign ratings is bound, sooner or later, to have negative consequences for the exchange rate of the rand. This, too, can potentially harm the poorer households.

Historically, because of the openness of the South African economy, a depreciation of the exchange rate has tended to raise inflation. In turn, a higher rate of inflation hits the most vulnerable harder, especially people who depend on basic grants which only get adjusted once a year at most. In particular, food prices and transportation costs rise on the back of rand depreciation. This reflects one of two things: either the need to import some of these goods (for instance petrol, which will over time affect the prices of public and collective transport) or linkages between the prices of foodstuffs and those of agricultural commodities on the global market. These items account for a larger part of total expenses for the poorer

households. For example, according to calculations by Statistics South Africa, food and non-alcoholic beverages account for 48% of consumption expenses for the 10% poorest households, compared with a weight of only 17% for the whole population.

The impact of a rating downgrade on financial markets may also have more direct implications for the poor than generally assumed. As mentioned earlier, poor households do not directly hold share portfolios, but some – in particular, older people who worked for a while in the public or private sector – rely on payments from pension or provident funds as their main, if not sole, source of income. If the value of financial assets declines, the money available in these pension and provident pools will shrink accordingly. Separately, research shows that some of the savings vehicles typically used by poor people, such as stokvels, are gradually being invested in financial assets to create wealth rather than being used solely for short-term purposes (such as, for instance, to cover funeral costs).² Again, any drop in the value of these financial assets would undermine the efforts aimed at creating wealth through such savings vehicles.

Finally, rating downgrades cast general doubts on the long-term economic and financial health of a country. This is because downgrades typically weigh on business confidence, undermining companies' willingness to invest in new productive capacities and boost the size of their workforce. At worst, businesses fearing a worsening economic future may shed jobs, resulting in an overall decline in the number of employment opportunities throughout the country. In South Africa, unemployment exceeds 27% of

² See '[Investments in stokvels gaining ground](#)' published on the Fin24 website on 9 July 2014.

the workforce, while the ability to find a job often provides the main chance to escape poverty for an individual and his or her family. Declining job opportunities would therefore risk aggravating the incidence of such poverty.

Arguably, many of the channels described above operate through investor sentiment and financial asset prices, including the exchange rate of the rand. One can therefore argue that so far, in particular since the latest rating downgrades, the reaction of financial markets has been rather benign. For instance, the yield on the 10-year South African government bond is still close to the average of the past five years, and the 5-year CDS spread on South African sovereign debt is around its lowest since late 2014. As for the rand, it has recovered by about 20% on a trade-weighted basis from the lows it had reached in early 2016.

Yet this relative stability is fragile, dependent on developments that may reverse in the not-too-distant future. The lack of a strong sell-off in either the rand or local bonds has more to do with a conjunction of favourable international factors than with investors downplaying the possible negative consequences of a downgrade. In particular, the factors referred to are the improvements in global economic developments, the absence of inflationary pressures in the advanced economies, and a still-accommodative stance by the world's major central banks. These factors have ensured that capital continues to flow to the emerging world, even to countries which have experienced a deterioration in their creditworthiness. But these flows could easily reverse. And amid tighter global financial conditions, investors would be more likely to differentiate between stronger and weaker sovereign credits. Should South Africa face another global shock, like it did during the 2008-09 global recession, its

recent rating downgrades could well make it more vulnerable to that shock.

Admittedly, some commentators claim that further downgrades to South Africa's sovereign ratings would not starve the country of foreign capital, as other investors – specifically, funds of a more speculative nature – would still buy domestic financial assets. However, apart from the fact that these investors would require a higher return on South African assets than recent historical norms, their investments would be more short-term in nature, most likely resulting in a higher volatility of market prices. This, in turn, would increase the climate of uncertainty facing domestic businesses, with negative consequences for fixed investment, job creation, and therefore poverty and inequality.

In conclusion, let me say that a sovereign rating is not a policy goal per se. Rather, it is a reflection of a broad range of economic, social, and political factors that constitute the creditworthiness of a country. Key among these factors is the strength of our institutions, including the Chapter 9 institutions, the judiciary, and the South African Reserve Bank. These institutions underpin our democracy and our creditworthiness. It is this creditworthiness that policymakers should strive to improve, for goals that include development and poverty reduction. As international experience shows, it is failure to generate sufficient economic growth and to maintain healthy fiscal and external balances that keeps large portions of a country's population in poverty. For South Africa's economy to become stronger and more resilient, and to make inroads into poverty, we need not only to avoid further downgrades; we should also ensure that the recent downgrades are eventually reversed.

Thank you.