Fitch refrains from downgrading while S & P downgrades

It is unfortunate that the leading credit rating agencies had to report on their latest credit assessments on South Africa at a time when events in the country such as the rising labour unrests are moving at such a pace in a manner that can influence the outlook quite materially. It is precisely this reason that may have encouraged Fitch to leave the credit rating on South Africa's long-term foreign currency debt at BBB, two notches above the threshold which distinguishes between investment grade and speculative grade. Nonetheless, even though Fitch did not revise the country's credit rating downwards per se, it did alter its outlook on its credit rating, from "stable" to "negative".

While Fitch refrained from downgrading, Standard and Poor's (S&P) did actually proceed with a downgrade of the country's credit rating to the lowest level of investment grade available. Fortunately, the fact that two out of the three credit rating agencies are still assigning a rating of at least two notches above junk status has helped to neutralise a more alarmist response. Furthermore, the fact that S&P assigned a "stable" outlook on the new, lower, BBB- rating must have appeased investors somewhat.

It would appear from their respective statements that the difference between Fitch's approach and that of S&P is that the latter has lost complete confidence in the government's ability to implement structural reforms needed to lift the country's sustainable growth rate, whereas Fitch has merely warned once again against failure to implement the National Development Plan (NDP) which aims to address such structural weaknesses.

Nonetheless, this should serve as a warning for South Africa to get its house in order and promote economic growth to avoid an actual ratings downgrade. It is essential for South Africa to maintain an investment grade credit rating in order to keep attracting capital inflows into the bond market. Such inflows are essential to accommodate the shortfall in the country's foreign exchange needs caused by the large magnitude of the current account deficit. A downgrade would probably put downward pressure on the exchange rate of the Rand, generating more acute inflationary pressures and forcing the hand of the Reserve Bank to raise interest rates. Economic growth would be damaged further as a consequence and consumers' living standards would come under increased pressure. An increase in long-term interest rates would also result in government having to pay more to service new debt it issued to make up for the shortfall between its revenue and expenditure.

Fitch specifically draws attention to the need for government to "adhere to tough expenditure ceilings". In addition, it also draws attention to the widening current-account deficit which "leaves the country exposed to shifts in global liquidity and risk appetite". The unequivocal warning implicit is that the government has to control its expenditure "or else". Furthermore, the government needs to accelerate structural reforms needed to increase the country's sustainable growth rate in such a way as to raise government revenue and enhance its ability to reduce its budget deficits and government debt. To this end, it is essential for the government to implement the NDP more comprehensively and in a more urgent fashion.

Fortunately, there are some positive inferences to draw from Fitch's reluctance to downgrade the country's credit rating. The rating agency draws attention to the fact that most of South Africa's government debt (91%) is denominated in local currency and has a high average maturity of 10 years. It sees this as limiting exchange rate and financing risk for the government. In addition, the central government has cash deposits of 6% of GDP. Coupled with the sophisticated nature of the country's capital markets, this supports flexibility in financing government deficits. It also sees the banking system as being very sound, with a capital adequacy ratio of 15.5%. Fitch also points to the high standards of governance in the business sector which are superior to its peer countries. Implicitly, the rating agency also seems to commend the policy of flexibility in the exchange rate which absorbs shocks in the financial system as well as the policy of pursuing inflation targeting. Although the rating agency reduced its assumption for South Africa's medium term growth potential to a range between 3.0% and 3.5% from a specific figure of precisely 3.5% previously, encouragingly, the agency still seems to acknowledge the capability of the economy to continue maintaining at least a moderate pace of growth in the longer term.

However, Fitch also commented on some of the broader non-financial structural weaknesses that urgently need to be addressed. Many of them are obvious but it is worth drawing attention to high levels of inequality and the low rate of growth in GDP per capita, which is inferior to other peer countries enjoying the same credit rating as South Africa. It also draws attention to frustration with levels of service delivery and the resultant wave of social protests.

Source : Econometrix 14 June 2014 and 17 June 2014