Features

Moody's downgrade was to be expected

Azar Jammine, the director and chief economist of Econometrix, at the annual Econometrix Noah BR Budget Conference held in Sandton, Johannesburg. PHOTO: SIMPHIWE MBOKAZI

Ratings agency's forecast will help neutralise adverse impact on rand

Azar Jammine

FOR several months now we have been commenting on the divergence between the credit ratings of South Africa by the three leading credit rating agencies. In June, Standard and Poor's (S&P) rating agency revised its credit rating on South Africa down to a BBB- rating, which is the lowest investment grade rating.

This contrasted with the rating by Moody's, of Baa1, which was two notches higher and the rating by Fitch, which at BBB, was still one notch higher than that of S&P. However, we also pointed out that whereas S&P had placed the new and lower credit rating on a "stable" outlook, the higher Moody's and Fitch ratings were associated with a "negative" outlook.

10%

Interest payments on government debt per year for next three years

The latter implied that there was a substantial probability that the latter two ratings agencies were going to revise South Africa's credit rating downwards when they next reviewed it. In the interim also, South Africa's economic growth floundered, turning out to be a lot lower than anticipated late last year when these ratings agencies last reviewed the country's credit rating.

Much of this underperformance in economic growth was the result of fairly aggressive strike activity between January and July. Under the circumstances, it was logical that the ratings agencies will have become more negative about potential revenue streams accruing to the South African government to enable it to reduce its budget deficit and limit the increase in its public debt.

The onset of renewed fears of electricity outages in recent weeks has dampened further any prospect of a pick-up in economic growth that might enhance government revenues. It was therefore highly probable that Moody's and Fitch would decide to revise the credit rating downwards when they reviewed it towards the end of the year. In the event, this is precisely what occurred on Thursday as far as Moody's is concerned.

Move back up to "stable" outlook should neutralise adverse impact

While the downward revision of the credit rating was largely discounted, one welcomes the change in the outlook on the new and lower credit rating of Moody's to "stable" from the erstwhile "negative" outlook. In many ways this is the more surprising move in light of recent downgrades of forecasts for South Africa's economic growth in 2014 and 2015 and the onset of renewed energy jitters.

The "stable" outlook implies that Moody's does not see a very high probability of having to revise the country's credit rating any further downwards. This leaves the agency's credit rating on South African at a relatively comfortable two notches above the threshold that distinguishes between investment grade and speculative grade.

The impact in reducing foreign purchases of South African government bonds should therefore be minimal. To a large extent, the fact that Moody's placed the credit rating on a "stable" outlook will help to neutralise any adverse impact on bond yields and the rand, which may have come about from Thursday's announcement of a lower credit rating.

Rand's depreciation more to do with dollar strength

It is tempting to suggest that the fall in the value of the rand vis-a-vis the dollar on Thursday was the result of a reversal of capital inflows as a result of the credit rating downgrade. However, such a view is misguided. The main reason why the rand depreciated from around R11.15 to the dollar, to its current level at around R11.25 has more to do with the dollar's strength against other currencies than with any particular rand weakness resulting from the credit rating downgrade.

Insinuations by European Central Bank (ECB) governor Mario Draghi to the effect that the ECB intended providing further stimulus to the European economy were interpreted as a further sign that the ratio of supply of dollars vis-à-vis euros, would decline, favouring dollar strength against the unified currency. As a result the euro depreciated to its lowest level in two years.

The pound followed suit following the intimation by Bank of England governor Mark Carney, that UK interest rates would likewise remain low for a long period of time. In other words, the rand's value against the likes of the pound and euro, did not depreciate much at all and cannot be attributed to the credit rating downgrade.

One welcomes the change in outlook on the the new and lower credit rating of Moody's to 'stable' from 'negative'.

It is also fair to point out that South Africa has not been alone in experiencing a credit rating downgrade. The same has happened to several other emerging markets over the course of the year, notably including Brics partners Brazil and Russia. South Africa's credit rating still remains superior to the ratings of those two countries.

Reasons given for downgrade are well documented

The reasons provided by Moody's for the credit rating downgrade did not contain any surprises either. According to Moody's, "poor medium-term growth prospects due to structural weaknesses, including ongoing energy shortages as well as rising interest rates" clearly result in fiscal deterioration. One suspects the energy issue was foremost in the mind of the ratings agency.

Nonetheless, even setting such concerns aside, structural constraints in the economy were also key reasons for the downgrade. Moody's referred to a deterioration in the investment climate, problematic labour problems and the potential for reduced portfolio inflows into emerging markets.

There can be little doubt that the ratings agencies are also going to focus on the success or otherwise in the implementation of the National Development Plan (NDP). The latter is seen as a litmus test for the kind of structural reforms needed to uplift South Africa's credit rating. In this way adherence to the NDP will be scrutinised during the first half of 2015 to inform decisions regarding further ratings downgrades.

Fitch can also be expected to downgrade the rating in December

Fitch, is similarly likely to downgrade South Africa's credit rating next month on reviewal. The reasons for doing so are almost identical to those set out by Moody's. It should be recalled that the decision made by Fitch in December last year to place the credit rating on a "negative" outlook was predicated on determining whether the configuration of the new cabinet after the May general election would be seen to enhance the likelihood of the implementation of the NDP and the potential growth spurt.

The intervening six months have not read much confidence that such an eventuality would take place after all. Indeed, one will be gratified if Fitch follows Moody's example in not associating a new and lower credit rating with another "negative" outlook. In this way, there might be some relief at the decline in the probability of ratings downgrades that might take the credit rating down to speculative or "junk" status.

Further ratings downgrades to levels below BBB- in the case of S&P and Fitch and below Baa3 in the case of Moody's, would be a disaster economically. It would almost certainly drive bond yields higher and the rand lower. As it is, interest payments on government debt are set to increase by almost 10 percent per year over the next three years, in contrast with the 6 percent-odd annual increases on vital functions such as education and health care.

The rising trend of the public debt-to-gross domestic product (GDP) ratio is compelling government to commit more resources towards the servicing of interest and dividends. In the event of South Africa's credit rating being downgraded to "junk" status, South African government bonds would be excluded by the Citigroup International bond index, with a resultant diminution in purchases of the country's government bonds, causing the cost of its long-term interest rates to rise further. Fortunately, for now this is not the most probable outcome despite the announcement of Moody's move on Thursday.

Azar Jammine is the chief economist at Econometrix

World Bank facing irrelevance?

the Globalist

Nancy Birdsall

FOR THE first time in its seven decade-long history, World Bank staff staged a work stoppage earlier this month. Staff are unhappy about the "change process", the ongoing internal reorganisation that president Jim Yong Kim initiated on his arrival at the bank, now more than two years ago.

The reorganisation process is the first of my two big worries about the World Bank.

The second is more troubling: The bank is well past its heyday as a major supplier of funds to developing countries. Short of a new vision, it faces an existential threat of growing irrelevance and even obscurity.

Rising incomes in big emerging markets reduce the demand for and logic of the bank's country loan model. I believe the world still needs a World Bank. But it needs a World Bank built for the development challenges of the 21st century, not the 20th.

I would lay the troubled reorganisation directly at the feet of Kim to fix.

Disruption is good, but two years of disruption with no clear end in sight is too much.

One tell-tale indication of the internal turmoil: Recently, the vice-president for Africa "resigned" just days before last month's annual meetings of the World Bank and the International Monetary Fund – only to be brought back two weeks later.

From the outside, it is easy to assume that a well-paid staff is grousing about losing status or position or even employment itself because of a reorganisation. But after living through and observing reorganisations at the World Bank over the last 30 years, I have the sense that the media get that part of the story mostly wrong.

What staff are concerned about is the continuing uncertainty that affects their work in the fields.

Practical questions like who is going to now be in charge of the water and sanitation programme I've been working on in Mali abound?

World Bank staff traditionally settle down after a reorganisation and get back to the business at hand. They know they have great jobs, mostly well paid and with a deeply satisfying mission. They also have passion about their mission to work for a better world.

But when Kim agreed to an emergency town hall meeting several weeks ago, 8 000 of about 10 000 staff attended, including 5 000 online (many connecting in the middle of their night from overseas).

Staff, it seems, do not believe this reorganisation is done – nowhere near done, let alone at the stage of fine-tuning. Their specific concerns are fundamental:

1. The new reorganisation has created 14 silos where there were four – and more, not fewer management layers.

2. Decision-making is more centralised, not less.

3. Transaction costs to organise teams are higher than ever and budgeting for work with clients is not flowing.

4. A few senior managers get bonuses, while a big budget cut is slashing travel budgets. Surely management should share in austerity.

It sounds as though structure and incentives are less aligned than before.

The second thing that troubles me about the World Bank is a deeper sign of the disjunction between what the world needs the bank to do, forcefully and with full funding, and its current limited mandate to support countries, for the most part one country loan at a time. In an internal reorganisation meant to strengthen "global practices", there has been no leadership on acquiring a "global" mandate.

Jim Yong Kim, the president of the World Bank Group. PHOTO: BLOOMBERG

As we first showed, almost 10 years ago, in this 2005 CGD report, the World Bank needs to have a mandate and a pot of money to set priorities to fund global investments.

The bank could then deploy its expertise and its resources for useful, long-term purposes such as:

1. To cover the incremental cost of solar or wind energy – instead of coal – in South Africa.

2. To help finance licensing fees to speed up access to new patented technologies on behalf of developing countries.

3. To co-finance, with the Global Environment Facility, payments to Indonesia for retaining its forests.

4. Most of all, to invest strategically in global goods to prevent global bads, rather than responding with repeated rounds of emergency relief after global bads strike.

I put this second worry, the growing gap between what the world needs from the Bank and what the Bank has the remit to do, to president Kim to fix, too.

A truly global mandate is not about big money, but about effective leverage of the bank's singular combination of financial heft, technical depth and global know-how in an institution designed for international collective action.

Kim must ask the bank's board to open a serious conversation about a new mandate and to ask the White House and the US Treasury to contribute actively to that conversation.

It is time for the World Bank to take on the 21st century – to further its mission and save itself.

Africa investors see through headlines

Karin Strohecker

EBOLA, terrorism and political upheaval – headlines from Africa over the past year seem a far cry from the inspiring "Africa Rising" story. But many newly found investors are sticking with the plot.

Even against the additional headwinds of falling commodity prices and the prospect of higher US interest rates, funds active in sub-Saharan Africa insist they still see a compelling growth story, driven by an uptick in regional trade, growing investment and a bulging middle class – the basis of the "Africa Rising" thesis.

"The most consistent growth that we see across the globe seems to be coming from Africa," said Boston-based Asha Mehta, who manages Acadian Asset Management's $380 million (R4 billion) global equity frontier fund.

"And it's likely to play out over the next five to 10 years."

Emerging markets at large have had a torrid couple of years, fearful of a cresting of China's economic boom and higher US interest rates. The more esoteric frontier markets typically weathered this storm, however, as they drew in a different sort of investor – one more atuned to diversification, tolerant of higher risk and locked into long-term themes.

But even for Africa optimists, the news has been trying.

Security threats posed by the Boko Haram and al-Shabaab militant groups, political upheaval in Burkina Faso or the devastating Ebola outbreak that has killed thousands in West Africa, reminded investors of the risks that have led many to steer clear of the continent for decades.

China's slowdown also jars African economies, whose fortunes have been tied heavily to minerals and oil exploration and which have soaked up swathes of direct Chinese investment.

But investors like Jonathan Stichbury, the chief executive of PineBridge East Africa, say growth in sub-Saharan Africa is much less reliant on commodity prices and much more driven by developments on the ground.

"These countries are enjoying a period of growth which I think is almost unstoppable," he said, citing factors like falling trade barriers, the elimination of currency controls in many countries and the emergence of a middle class.

230%

Rise of 11 African countries' middle-class households in 14 years

For instance, the number of middle-class households in 11 of sub-Saharan Africa's top economies, rose by 230 percent in the past 14 years to 15 million, according to a Standard Bank report.

That number is expected to swell to 40 million by 2030.

Sub-Saharan African growth should top 5 percent this year, the International Monetary Fund says, rising to 5.8 percent in 2015.

Nigeria, Africa's biggest economy, should grow 7.3 percent next year, while Kenya is in line for a 6.2 percent boost.

Compare that with global growth forecasts of 3.9 percent.

Oil pain for some

Only a quarter of African countries actually produce oil, data from the African Development Bank (AfDB) shows. Some of the continent's poorest countries such as Liberia and Sierra Leone spend 15 percent of their income on oil imports, the AfDB says. For them, oil's 25 percent fall this year will be a boon.

Yet exporters like Nigeria and Angola will be hard hit. If US oil futures slip towards $70 a barrel – around $6 lower than current levels – and stay there a while, Angola and Gabon would face a three-notch ratings downgrade, while Nigeria risks being downgraded 1.1 notches, BNP Paribas calculates.

Fund flows paint a mixed picture. Recent months have seen a slowdown in equity investment flows, with funds dedicated to sub-Saharan Africa but excluding South Africa clocking outflows of $77m this year, adding to last year's $23m losses, according to EPFR Global.

MSCI's emerging and frontier Africa ex-South Africa index has gained 1.2 percent this year, almost on a par with global shares.

But Nigerian equities have slumped, with the all share index down 20 percent this year as falling oil prices have dampened investors' appetite for stocks in the oil exporter.

Mehta said after adding to her sub-Saharan equity holdings over the past year, she was not planning to increase her exposure. "African markets, as compelling as they are, do just have significantly less liquidity than other frontier countries."

The main share index in Africa's largest economy, Nigeria, has a market cap of $70b compared with the $749bn in India's main index or $476bn in Russia. – Reuters