

Comment

Thinking about some narratives for 2018

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Introduction

On a number of fronts, 2017 has been a tumultuous year for South Africa. The country suffered the latest setback on Friday when S&P Global cut SA's local currency (LC) sovereign credit rating to sub-investment grade, while Moody's put its rating on a 90-day review for a downgrade.

The year is set to conclude with the much-anticipated ANC five-yearly elective conference. The outcome of the conference has the potential to shape the fortunes of the economy in 2018 and beyond. Against the backdrop of unusual uncertainty, this note outlines three possible scenarios for 2018. We did not attach specific numbers to the outcomes and acknowledge that it is virtually impossible to provide for all the nuances. Rather, the idea is to outline a number of possible narratives and the likely macroeconomic implications. We did not assign probabilities to the different scenarios.

Setting the (unpleasant) scene

The October Medium-Term Budget Policy Statement (MTBPS) was a notable disappointment as it failed to provide any guidance on how government planned to consolidate the public debt over the medium term. This raised the risk of further credit rating downgrades.

Over the past week, all three major credit rating agencies gave their latest verdict on SA's creditworthiness. Table 1 provides an overview of the ratings after the latest decisions. After downgrading the rating to sub-investment grade in the wake of the ill-fated March 2017 cabinet reshuffle, **Fitch** kept both SA's foreign and LC rating at one notch below investment grade (IG).

S&P Global cut SA's long-term foreign currency sovereign credit rating by another notch to 'BB' from 'BB+'. This means that SA is now two notches below IG. Of particular importance is that S&P also lowered the local currency (LC) rating to sub-investment grade, i.e. to 'BB+' from 'BBB-'. Both ratings were assigned a stable outlook, implying further near-term downgrades are unlikely. The LC rating of S&P and Moody's is used as the criteria to determine the inclusion of a country's bonds to key global indices, most notably the Citibank World Government Bond Index (WGBI). The downgrade to below IG from S&P, which means that two of the three major agencies have junked SA bonds, has already forced SA out of the Barclays Global Aggregate.

For a country's bonds to fall out of the WGBI, the LC rating from both S&P and Moody's has to fall into sub-investment grade. On this note, there was somewhat better news on Friday. Moody's decided to maintain SA's IG foreign and LC ratings. This implies that we will remain in the WGBI, for now. However, Moody's placed both SA's long-term foreign and LC ratings on a 90-day review for a downgrade. This suggests that if the February 2018 Budget does not include credible measures to improve SA's medium-term GDP growth outlook and stabilise public debt levels, Moody's will cut the ratings to junk status by late 2018Q1. This will trigger a WGBI exit and could potentially have a significant (albeit highly uncertain) adverse impact on especially the rand exchange rate and the value of SA government bonds.

Table 1: South Africa's foreign and local currency ratings

	S&P Global	Moody's	Fitch
Long-term foreign currency	BB	Baa3 (BBB- equivalent)	BB+
Notches above/below IG	-2	1	-1
Outlook	Stable	On review for downgrade	Stable
Long-term local currency	BB+	Baa3 (BBB- equivalent)	BB+
Notches above/below IG	-1	1	-1
Outlook	Stable	On review for downgrade	Stable

Source: S&P, Moody's, Fitch, BER

In response to the action taken by the rating agencies, the Treasury said in a statement that: "The 2018 Budget will outline decisive and specific policy measures to strengthen the fiscal framework, as an important contributor to improved confidence of all stakeholders..." In terms of the possible magnitude of these measures, the MTBPS indicated that additional spending cuts or tax increases of R40bn would be required from 2018/19 to stabilise public debt below 60% of GDP. The current Treasury fiscal baseline already assumes R15bn worth of tax hikes and roughly the same amount of expenditure cuts for 2018/19.

Of particular significance is that last week's rating action seems to have jolted government into action¹. The Presidency, a higher authority than the Treasury, issued a statement on Monday in which it seemed to rubber stamp the figure of an additional 40bn (R15bn in revenue-raising measures and R25bn in expenditure cuts) to stabilise public debt levels. In our **MTBPS comment**, we pointed out that the weak fiscal outlook should not be taken at face value and that the February Budget was likely to present potentially vastly different numbers. Recent developments support this argument.

If there is follow-through on the R40bn in additional measures, the February 2018 Budget could potentially extract up to R70bn from an already weak economy. Fiscal policy will then be a material drag on real GDP growth in 2018. However, the trade-off from not doing this is that the situation could be worse if we fail to

¹ It could be argued that the rating agencies have provided a much-needed feedback mechanism to bad policy choices that financial markets (because of ample global liquidity and yield chasing) have been unable to do.

implement debt-stabilisation and growth-supportive measures and SA is forced out of the WGBI². In any event, GDP growth is likely to remain sub-par in the near future.

Scenario I: Continued WGBI inclusion

At least partly, recent rand strength in the wake of the S&P downgrade may be due to increased optimism that Deputy President, Cyril Ramaphosa, is the frontrunner to be the next President of the ANC. This would imply that, assuming the ANC maintains its majority, he ultimately becomes SA President after the 2019 general election.

Because Mr Ramaphosa's key backers include Cosatu and the SACP, we are sceptical about his ability to engineer a process that results in much-needed structural reforms that could lift medium-term GDP growth. However, a Ramaphosa victory should provide a welcome boost to business and consumer confidence, and support domestic financial markets (stronger rand exchange rate, lower government bond yields). This will especially be the case if his victory, along with a reformed ANC National Executive Committee, results in quick action on the following:

- A credible stance against **corruption** and **state capture**. This would most likely include new leadership at some key ministries, including mining, the energy department and possibly the National Treasury, as well as SARS, etc.
- Sound boards and management at leading state-owned enterprises, including **Eskom**
- A firm policy stance that SA will not pursue a **nuclear deal**
- The possible early recall of **President Zuma**

Under these conditions, we may be surprised at the extent of the boost to confidence. Moody's is assumed to keep SA's credit rating at IG after their 90-day review, thus ensuring SA's continued inclusion in the WGBI. However, a Ramaphosa victory will not be sufficient to keep Moody's at bay. The February Budget will need to deliver on the additional "austerity" measures outlined by the Presidency. If accompanied by some measures to boost medium-term growth, this should prevent a Moody's downgrade.

Unfortunately, it is not clear that the politically induced confidence boost will be sufficient to outweigh the negative impact on 2018 growth from a notable fiscal contraction³. Given the magnitude of the fiscal package, it will most likely have to include a 1% rise in the **value added tax** rate (or potentially the implementation of VAT on fuel) and would need to show more restraint on the **public sector wage bill**. On the wage bill, an option could be to freeze the pay of senior staff, including ministers, deputy ministers and director generals. These measures will be very unpopular and opposed strongly by the trade unions and possibly public servants. Therefore, the implementation of such measures is conditional on the emergence of new, strong leadership who are willing to take and stand by difficult decisions.

² As outlined in scenario II, under favourable global conditions, a WGBI exit may not be as dire as previously thought.

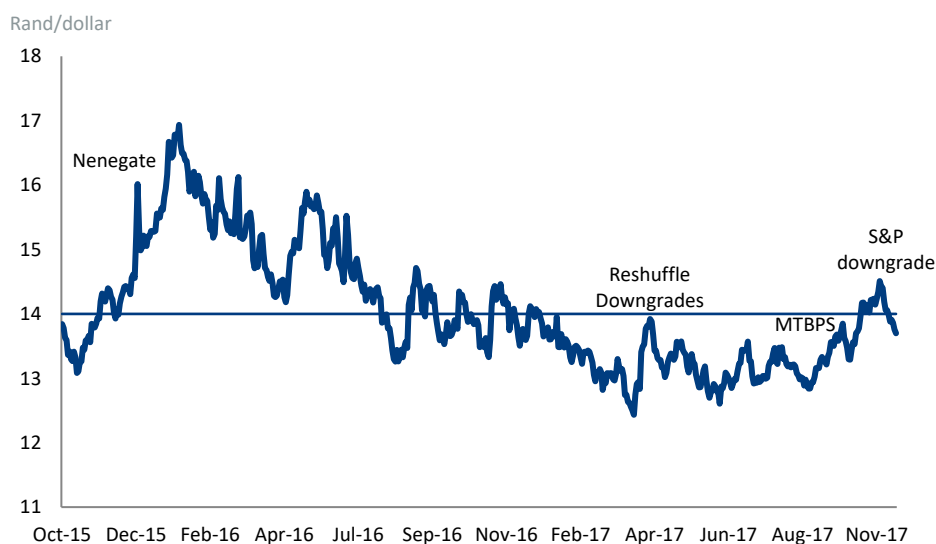
³ If Mr Ramaphosa can show some quick wins on the areas highlighted above, fiscal policy could be less restrictive and still appease Moody's.

A Ramaphosa victory, accompanied by measures to rein in the rise in public debt, will put SA on a much better medium-term course. However, even in this positive scenario, growth in 2018 is likely to remain poor. The rand should be stronger than current levels, inflation lower and it may even provide the SA Reserve Bank with some room to reduce the policy interest rate. The financial market reaction assumes that global conditions remain reasonably favourable for foreign capital inflows to emerging markets.

Scenario II: WGBI exit with favourable global conditions

To a large extent, the magnitude of the impact on domestic financial markets from a WGBI exclusion depends on the global environment. Figure 1 highlights how, since late 2015, favourable global liquidity conditions have supported the rand exchange rate through a number of adverse domestic developments.

Figure 1: Yield-chasing investors outweigh domestic woes



Source: Reuters, BER

Assuming that global liquidity conditions remain supportive, the hit to foreign capital flows from a WGBI exit should be more contained. In this environment, the impact of forced selling of SA government bonds by WGBI investors on SA capital flows could be more contained.

Increasingly, global investors - including large hedge funds - are prepared to buy junk-rated government bonds. This is at the right price, i.e. they demand higher interest rates (returns) as compensation for the additional risk. This implies that in the wake of a WGBI exit, the rand exchange rate could initially be substantially weaker (previous modelling suggested R16.50/\$ and weaker) and SA government bond yields notably higher. Once a new level is reached, that in the non-index tracking investor's mind adequately compensates them for the additional risk, there may be renewed appetite for SA bonds. In this scenario, the initial negative knee-jerk market reaction to a WGBI exit may be relatively short-lived.

However, these investors are likely more fickle, implying increased volatility on domestic financial markets. In sum, there should be little doubt that a WGBI exit will be negative for SA financial markets and the real

economy. However, under favourable global conditions, the impact may turn out to be less negative, and potentially less sustained, than previously assumed in our scenario runs.

While the blow to domestic asset prices could be relatively short-lived and contained, the conditions that are likely to result in a WGBI exit suggest that the real economy could be under significant pressure.

Moody's are likely to downgrade SA's rating for a combination of the following reasons:

- The ANC's elective conference delivers a leadership that is unlikely to take the country on a new path / The ANC is unable to elect a new leadership and the current political muddle through is prolonged
- The **February Budget** fails to provide a credible fiscal consolidation / growth-enhancing plan

Under these conditions, business and consumer **confidence** may take another leg down. In particular, **private sector fixed investment** may decline sharply in this scenario. On the consumer front, durable goods consumption should remain under pressure.

Scenario III: WGBI exit compounded by less favourable global conditions

The triggers and timing of a WGBI exit is similar to scenario II, i.e. it happens towards the end of 2018Q1. In the absence of a major unforeseen event, it is unlikely that the current favourable global conditions will have changed much in three months. The global environment is assumed to initially remain favourable.

However, it could be a different story in the second half of 2018. By that time, the US central bank (Fed) may have hiked the policy rate by an additional 50-75bps. If US inflation is on a firmer upward trend, the Fed may be signalling a faster pace of future rate increases. So this scenario could result in multiple periods of strain on foreign capital flows to SA. The initial trigger is a WGBI exit. As outlined in scenario II, the initial knee-jerk negative reaction to this may be short-lived. This is then followed by a global event-driven second hit to foreign inflows later in 2018⁴. The macroeconomic implications, which are not limited to 2018 but rather play out in 2019 in particular, could include the following:

- The **rand exchange rate** is substantially weaker.
- The weaker currency pushes **CPI inflation** higher, although the biggest impact should be in 2019.
- The SARB may be forced into hiking the policy interest rate in the latter stages of the year. This is both to preserve capital inflows from a balance of payments perspective and to prevent an untoward rise in inflation expectations.
- Higher inflation and interest rates erode real household disposable income, mainly in 2019.
- The hit to business confidence results in particularly poor real **private sector fixed investment**.

⁴ An alternative version of this scenario could be that Moody's grants us a reprieve in March 2018, but is disappointed by a lack of follow through on promises made. A downgrade and a WGBI exit follows later in 2018, at a time when the sentiment towards emerging markets is less positive. The adverse global event(s) could be a number of factors and is not limited to faster than expected Fed policy interest rate hikes.

- The **fiscal deficit** and **overall government debt** are higher in this scenario. The higher debt levels, inflation and policy interest rate in this scenario push up the 10-year government bond yield. Other asset prices, including the equity market and real house prices, should also perform notably weaker in this scenario.

Summary

Risk events over the next three months will to a large degree determine SA's economic prospects in 2018 and beyond. Given the fiscal straightjacket that the country finds itself in, even a market-friendly outcome at the ANC elective conference may not be able to prevent a poor real GDP growth outcome (sub 1%) in 2018. However, the groundwork for an improved medium-term growth outlook could be laid by sound ANC leadership choices. From that perspective, the outcome of the ANC elective conference is crucial.

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