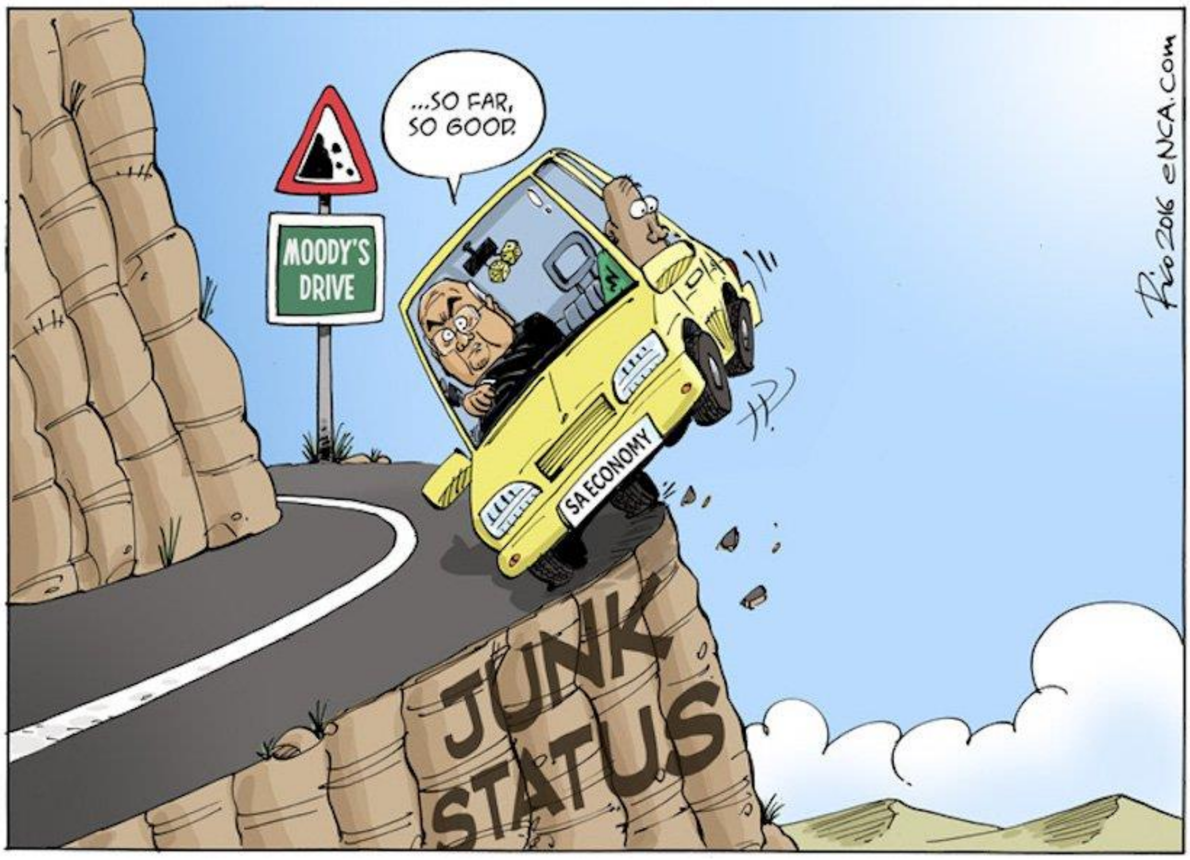
The consequence of the downgrades

While we speculate about the consequences of the rating downgrades, I believe an equally important point is how did we get into this problem. It is only if we understand this, honestly, that we will know what we have to do to return to investment grade status.

When you rate the viability of a country there are a number of key factors you consider.

- Is the country politically stable and do you trust the political leadership to do what is right for the country.
- Do they manage the country's income and expenditure in a responsible way. Economists refer to this as the fiscal deficit.
- Are they importing more than they export and if they are, can they fund the shortfall through overseas borrowings. Economists refer to this as the current account deficit.
- Is the government's borrowings reasonable for a country, especially for a developing economy country.
- Is the economy growing. Fast growth can hide many sins, slow growth highlights them



Let’s look at some of these factors

When Mr. Manuel left finance, South Africa’s debt was 28% of its Gross Domestic Product. The financial crises happened and government spent to compensate for this. Many other countries did the same. However, while South Africa did spend on improving the infrastructure, it also increased the number of government employees and the salaries they received. At times the cost of central government was increasing at 30%p.a.

Today, South Africa’s government debt hovers in the upper 50’s%. This, however, does not take into account the government’s guarantees to our malfunctioning state owned enterprises. All of the rating agencies have flagged this. If you take these institutions into account the debt ratio rises to 70%.

The general guideline for developing countries like ourselves is that this figure should not be above 50%.

In recent years South Africa’s economic growth rate has been much lower than that of most comparative countries. The real problem for South Africa is that the rating agencies do not see the economic growth rate recovering to a reasonable rate in the near future. If your economy is growing at 1% p.a. in real terms, and your population is growing faster than that then the average resident is getting poorer year by year. I was at a meeting where one of South Africa’s leading experts in the labour field spoke at some length on the disappearing middle class in South Africa. As he said, in South Africa, either be poor or very wealthy but don’t be in the middle.

As we saw in the recent budget the government has spent us into a fiscal straight jacket, where the only solution is to cut expenditure (which governments don’t like to do because it affects their supporters) or increase taxes, as they did. To reduce the fiscal deficit to 3%, a general norm for developing countries, means spending less, taxing more or growing the economy faster. To me raising taxes seems the most likely. This is likely to affect economic growth.

Improving the current account is not easy to do. Many of our exports depend upon factors outside our control, e.g the demand and price of commodities.

Perhaps one of the most important consequences of the downgrades showed us just how far we have fallen from economic and investment grace

Let’s now look at some of the more direct consequences of the downgrade.

There are many overseas institutions whose mandates do not allow them to invest in sovereign or other bonds whose issuers do not have an investment grading.

At the moment about only 10% of the South African Government bonds are foreign, 90% are domestic bonds.

There are also world bond indices which are followed by institutions and investors, especially those who follow a passive investment approach.

There are 3 major world bond indices and for each one the rules are somewhat different. For example, the one needs two rating agencies, one of which is Moody's, to reduce the rating to junk and exclude that countries bonds from its index. That is why the decision by Moody's to rate as just above junk was so important. If Moody's does move us to junk status we would fall out of some of the indices. We don't know what the exact outflow as a result of the downgrades could be, but it is estimated to be in the region of R120 billion to R170 billion.

It must also be remembered that there could be different ratings for bonds issued domestically and those issued overseas.

Just looking at the simple economic relationship between supply and demand, if demand is reduced one would expect prices to fall. In the case of bonds this means that interest rates will go up, unless supply is reduced.

One would therefore, other things being equal, expect the cost of money to rise. Some suggest that this has already been priced into current bond prices. One can contrast this with what happened when Mr Nene was replaced as Minister of Finance. The move was unexpected and the market reacted with shock. Government bond interest rates rose to over 10%. The reaction to the recent downgrades was much more muted because the downgrades caught no-one by surprise.

At present yields South African bonds seem to be priced in a range which is similar to that of other countries' bonds who have been rated as junk.

One may ask, why will investors buy junk bonds. The answer is that compared to the low interest rate on developed world bonds, the return on junk bonds look good. This is a case of the classical trade off between risk and return.

My own feeling is that the downgrade is more likely to cause interest rates to rise than to fall. It was previously argued that the Reserve Bank might reduce interest rates in South Africa. I think that the downgrades have postponed this.

The tendency for markets to price the future into the present can lead to some counter-intuitive reactions.

A good example of this has been the strengthening of the Rand. There were some dire predictions that the Rand could fall to R14,R15,R16 and even R20 to the US Dollar. That may still happen in the future, but it wont be the downgrades that caused it. Rather it will be the poor state of the economy making us less and less competitive and investment worthy.

Another prediction which did not happen was the collapse of the JSE. The reason for this is that for the major companies on the JSE their earnings are becoming less and less Rand based. Indeed, they may prefer the rand to be weak rather than strong.

As South Africans we tend to think that the world revolves around us. We sometimes forget that what is happening out of South Africa is just, if not more important, than what is happening in South Africa.

<u>What should South Africa do to fix the problem.</u>

The simple answer is that we have to fix the problems that gave rise to the downgrade in the first place. I mentioned some of these at the beginning of my letter.

We also need to bring the parastatals to heel. They are out of control and are causing severe damage to the South African economy.

We need to support the middle class rather than following policies that are eliminating it.

We need to restore confidence in South Africa as a good place to live in and invest in. I often hear the view that South African companies are boycotting investing in South

Africa. I wonder if its not just a case that they find more attractive conditions outside of South Africa than in South Africa.

We need to fix the politics of South Africa.

Personally, I find it hard to see a solution under the current political dispensation.

Other countries who found themselves in the same position as we are, were able to recover.

Some also, it is true just continued to operate as failed states. But it can be done by creative leadership which is not corrupt and which is willing to think out of the box.

If I look at South Africa we have great natural beauty. It is there, we don't need to build it, we just need to keep and use it effectively. We have millions of unskilled workers. If South Africa was to aim at bringing in 20million overseas tourists a year, what a difference could that make.

Kind regards

Brian Goodall