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Melbourne's link with SA wages

TWO things in the news caught my eye this week. The first was that Melbourne has taken the top spot in the Economist's Intelligence Unit's annual most liveable cities survey for the fifth year running, and the second that the Reserve Bank has issued a stern warning about above-inflation wage increases.

The two might seem unrelated, but if you listen in on as many upper middle-class dinner party conversations as I do, the link is there — a ratings downgrade.

A few weeks ago South African Chamber of Commerce and Industry president Vusi Khumalo spoke openly about the inevitability of SA's credit rating being downgraded to junk status. What made his pronouncement so shocking was not how blunt he was in his conviction, but that he was the latest in a long line of knowledgeable individuals who have recently told me exactly the same thing.

One of the privileges of my job is that I get to hear a lot of things off the record. "Bron, it's not a matter of if anymore, it is a matter of when," they say when I've been bold enough to ask for their honest opinion. "It's just a matter of time," say others. "If global conditions don't improve, there is no way we can pull ourselves out of this mess on our own."

Others are so confident they already have timelines and contingency plans in place for when the downgrade does take place.

I have to admit that in the past few weeks it has been increasingly hard not to believe them.

Falling commodity prices and slowing growth in China, coupled with the expectation that the US Federal Reserve will start hiking rates next month, have all taken their toll on the country's economy. Earlier this week the rand fell to its lowest level against the dollar since 2001. The week before, the purchasing manager's index fell for the second consecutive month to a year low of 48.9 — well below the 50-point mark that serves as the

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dividing line between expansion and contraction in the manufacturing sector.

Business confidence is at a historic low and job cuts in the mining industry both locally and abroad don't paint a pretty picture.

Indeed, as I write this, my husband tells me that nearly $1-trillion has bled out of emerging markets over the past 13 months — roughly double the amount that left during the financial crisis. None of these external factors have been helped by the fact that we are struggling to keep the lights on and continue to battle persistently high fiscal and current account deficits.

It goes without saying that being downgraded to junk — noninvestment grade — status is pretty catastrophic. Apart from increasing the cost of foreign borrowing, a downgrade would also cause substantial capital flight, as investment schemes with a mandate to invest in investment-grade bonds would be forced to sell large holdings. This in turn would result in a rapid currency devaluation and significant rise in the cost of living.

Along with the capital flight, currency devaluation and increasing debt costs, Rand Merchant

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Bank estimates that only 30% of countries that have been "junked" are able to regain their investment-positive status.

It shouldn't come as a surprise then that as soon as I explain this to people the next question they ask is, "Where is the best place to emigrate?" Which would explain why Melbourne has been so front of mind recently.

The good news is that we are still a good few clicks away from this happening. Rating agencies take a holistic view when evaluating the ability of a country to repay its sovereign debt, taking into account factors such as economic growth, fiscal balance and public debt, and the current account balance.

Of the three rating agencies, Standard & Poors (S&P) has SA on the lowest rung of its investment-grade ladder at BBB-, but with a stable outlook. The fact that the agency reaffirmed its "stable outlook" in June means it is confident economic growth will remain within its expectations of 2%-3% for the next two years and that the government will be able to rein in its fiscal ambitions.

The other two rating agencies tell a similar story. Both Fitch and Moody's have SA two steps away from junk status at BBB and Baa2 respectively, with a negative outlook, although Moody's only downgraded SA to Baa2 in November. Both have previously raised concerns over the burgeoning budget deficit, the vulnerability of the current account deficit and the slow pace of economic growth, but much as is the case with S&P, it will take a significant unexpected deterioration in all of these things for them to further downgrade the country's credit rating.

It was heartening to read a statement released by Moody's last week that said the country is on track to stabilise government debt at 48% of gross domestic product. Although this is relatively high, it is significantly below that of emerging market peers such as India and Brazil. The Reserve Bank has also

> **Rating agencies take a holistic view when evaluating the ability of a country to repay its sovereign debt**

spoken out on the dangers of steep wage settlements; if the public sector is getting several notches above inflation, it will be very difficult to convince the private sector to accept an increase of only 5%-6%.

Another useful metric in evaluating the ability of a country to repay its sovereign debt is credit default swaps (CDS). A CDS is an instrument you can buy to hedge or insure against a possible government default.

The CDS "spread" is the premium you need to pay to insure against possible default. In other words, the higher the risk of a default the higher the spread and the higher the premium you will pay to be covered in the event of a default. In this way, CDSes are a useful way to measure the market's view on how likely a country is to default on its sovereign debt.

The South African five-year CDS spread is in the region of 245 basis points, an increase of about 85 points since December last year. To put this into perspective, the UK has a CDS spread of around 19 points, while Mexico and Spain are at 138 and 99 respectively. A rising CDS such as this is obviously a bad sign, but what rating agencies really want to know is whether SA's credit risk is rising relative to emerging-market peers.

In this respect, SA's situation is ambiguous, being grouped with other medium- to high-risk countries such as Brazil, Russia and Turkey, while significantly underperforming rising stars such as Malaysia, Thailand and Mexico.

The bottom line is that the question of whether SA will experience a credit rating downgrade remains up in the air.

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