EFFICIENT GROUP

ECONOMIC COMMENTARY

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Newsletter

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AN IMPORTANT DOWNGRADE DISTINCTION: LOCAL AND DOLLAR DEBT

Moody's, the credit agency, is set to review South Africa's credit rating within the next couple of weeks. There seems to be a lot of confusion in terms of what credit ratings are, who uses them, and why a country's credit rating is important. To explain these topics, consider the following example.

Like your own personal credit rating that you use to borrow money from a bank, governments and large corporations also have credit ratings. They don't necessarily have to go to banks to borrow money, they can simply issue their own loans (in the form of bonds) in the marketplace (the bond market), which investors (savers) can then buy. Investors who buy these bonds earn interest (the coupon rate), which is determined to a large extent by the credit rating of the government or institution who issued the bonds. Just on a side note, there are other factors that determine the yield, i.e. inverse-price, of a bond, which also contributes to the total return of holding a bond. For simplicity, however, we only consider the higher risk, higher reward impact of credit ratings on interest (coupon) rates.

Globally, there are three major institutions who provide credit ratings on governments and corporations: Moody's, Standard and Poor (S&P), and Fitch. Like banks that do credit ratings on individuals who want to borrow money, these institutions consider multiple variables to determine the credit rating of a government or corporation. In the case of a government's credit rating, the agencies consider: (tax) revenue, total expenditure, budget deficits, debt levels, economic growth, fiscal and monetary policy, and political will, to name but a few. This rating then informs the marketplace of what interest rate should be paid if a government or corporation wants to issue bonds in the marketplace. There are other factors like competitiveness, liquidity, sentiment, etc. that also impact the interest rate, but let's keep it simple.

So, if a credit agency determines that there is a high probability that a government (or corporation) will not be able to repay their loans (bonds), they downgrade such a government's bonds to sub-investment grade or junk status.

Consequently, a government will then have to pay higher interest in the marketplace if they want to issue bonds (borrow money). The higher the probability that a government will default on their loans, the lower the credit rating.

Now, back to Moody's and their upcoming review of our government bonds. Because the bond market is such a large and liquid market where many different bond-types, with different durations, of all types of countries are traded, it's easy, even for large institutions (like pension funds), to get lost. Citigroup (a large global bank), therefore, created a bond index – a basket of investable bonds, which anyone can simply buy to gain exposure to the global bond market. By being included in the Citigroup World Government Bond Index (WGBI), investors globally own roughly R100 billion worth of South African government bonds. However, to remain in this index, Citigroup require S&P or Moody's to rate the local government bonds of a country as investable (not sub-investment or junk).

At this point it is important to distinguish between dollar-denominated bonds and local (rand)-denominated bonds. Luckily, Citigroup only require that our rand-denominated bonds be investment grade. This requirement is easier to maintain as it excludes currency volatility and those factors that impact severely on a currency (like politicians doing stupid things, like firing a finance minister for example). Currently, S&P already rated South Africa's government bonds as junk. Should Moody's also downgrade our local-currency debt, we will be excluded from the WGBI and a force sell-off of our bonds will occur. This will most likely lead to dollar shortages, leading to a depreciation of the rand and finally, an increase in the interest rate we offer for new government bonds.

But, we're confident that Moody's won't downgrade our local debt. They might consider downgrading our foreign debt, but even that would be somewhat of a stretch. It is important, however, to understand that should they downgrade our foreign debt, we will not fall out of the WGBI. Also, most of the negative impact of a foreign-debt downgrade should already be priced into markets and would, therefore, not do too much to the rand or JSE.

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