Impact of the Ratings Downgrade on the Public Service

Introduction

South Africa's political risk is heightened in the wake of the Cabinet reshuffle by President Jacob Zuma on 20 March 2017. This was immediately followed by sovereign foreign currency credit rating downgrade to sub-investment grade by S&P, and later Fitch (on both foreign and rand-denominated debt) to one notch above sub-investment grade. Moody's has also placed South Africa under watch for possible downgrades. These developments have highlighted the fact that politics and institutions matter for the economy and social stability, and these two factors will be at the heart of our politics for many years to come.

The reshuffle of cabinet ministers by President Zuma on 31 March 2017, including the firing of the Minister of Finance Pravin Gordhan, has received extensive attention in the press and public discussion. There was sweeping outrage from the public, condemnation from some ruling party politicians, and a defensive campaign by the President and those close to him.

Sections of the labour movement condemned the move and asked for the President's resignation, while organised business group Business Leadership South Africa (BLSA) declared it a “political and economic low point of our young democracy”.[1] The President, who has yet to justify exactly why he chose to reshuffle the finance minister, and his supporters have nevertheless rallied around a narrative that the move aims to promote radical economic transformation, a notion that remains nebulous. The Treasury had released a slew of statements, some claiming continuity will be the order of the day, and others declaring a radical change in approach, leaving markets and the country scrambling to understand what this all means.

Amid all the changes, two broad narratives have emerged around what the ratings downgrade means. The downgrade has been billed as the tipping point in a long-brewing crisis resulting from a toxic mix of cronyism and economic mismanagement that has undermined the institutions meant to safeguard the provision of economic justice for all. The downgrade is seen as a serious disaster that would devastate the ability of government to cheaply borrow the money it needs to keep functioning. Sections of the ruling party have roundly condemned the ratings agencies as imperialist institutions with a track record of startling failure, most notably in the financial crisis of 2008. The new finance minister has been more reconciliatory towards the agencies, and the investor community broadly. He undertook a trip to Washington DC as part of the ritualistic International Financial Institutions Spring meetings, and took an opportunity while there to travel to New York to engage with investors.

Understanding the impact of the ratings downgrade, the reshuffle, and what else is at risk in an increasingly complex economic crisis is extremely challenging. For public service workers, the changes and uncertainty throw major questions over upcoming public service wage negotiations.

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[1] https://www.businesslive.co.za/bd/business-and-economy/2017-04-18-business-leadership-sa-seeks-talks-with-jacob-zuma/

With a government that is even more fiscally constrained than previously believed, and growing instability in the leadership across government, including in the Ministry of Public Service Administration, it's difficult to understand what this means. This article will examine the impact of the downgrade, the reshuffle, and the resultant spillover effects on the public sector.

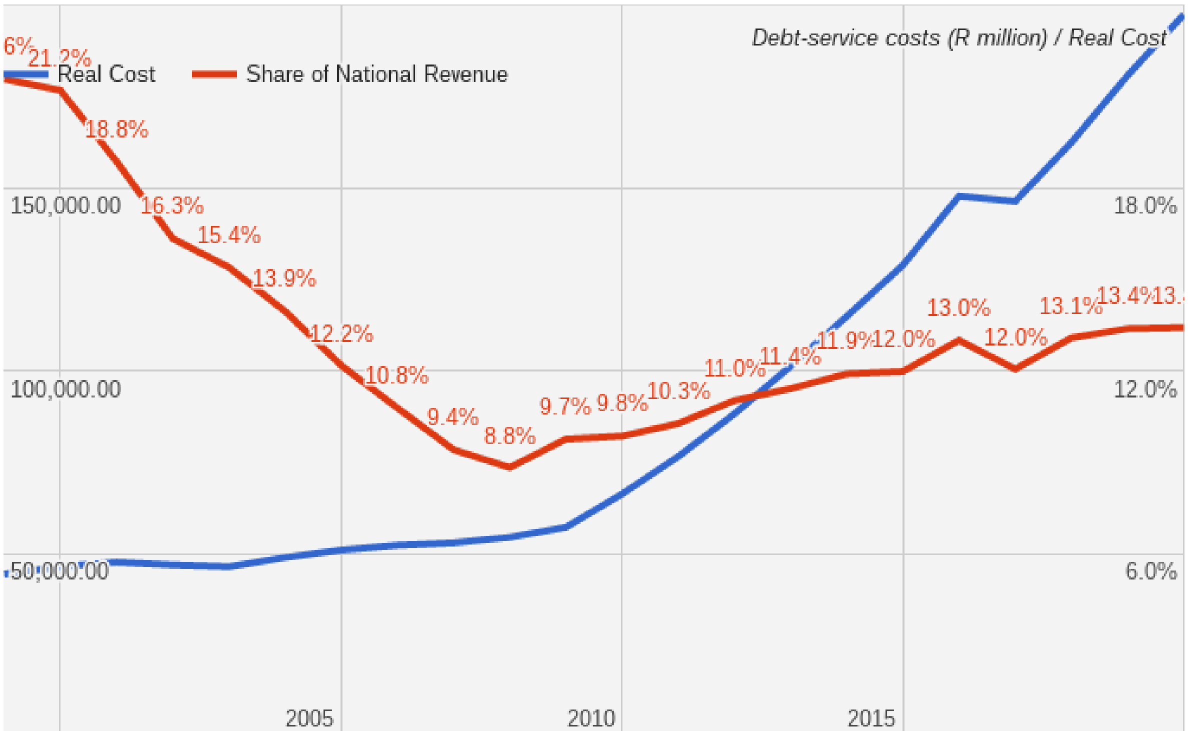
Impact of the Ratings Downgrade

Understanding the impact of a sovereign ratings downgrade is complicated, particularly by the fact that there have been extremely few examples of downgrades actually happening. Only a handful of countries have lost investment grade rating. Over the past 20 years, at least 20 countries have lost investment grade rating, as can be seen in Table 1. Of these, a vast majority, lost their rating as a direct result of a broader economic crisis. While there are still lessons to learn from these economies, it's hard to differentiate the impact of the downgrade from the impact of their broader crisis. In part, this is why the widely circulated statistics that it takes an average of seven years to recover from a downgrade should be taken with a pinch of salt. Yet still, the implications of a downgrade and the time it could take for South Africa to be back on its feet cannot be underestimated. Many of these countries were mired in unique economic problems that prevented them from regaining their rating, and cannot act as useful guidelines for South Africa. South Africa has its unique set of challenges that require close attention.

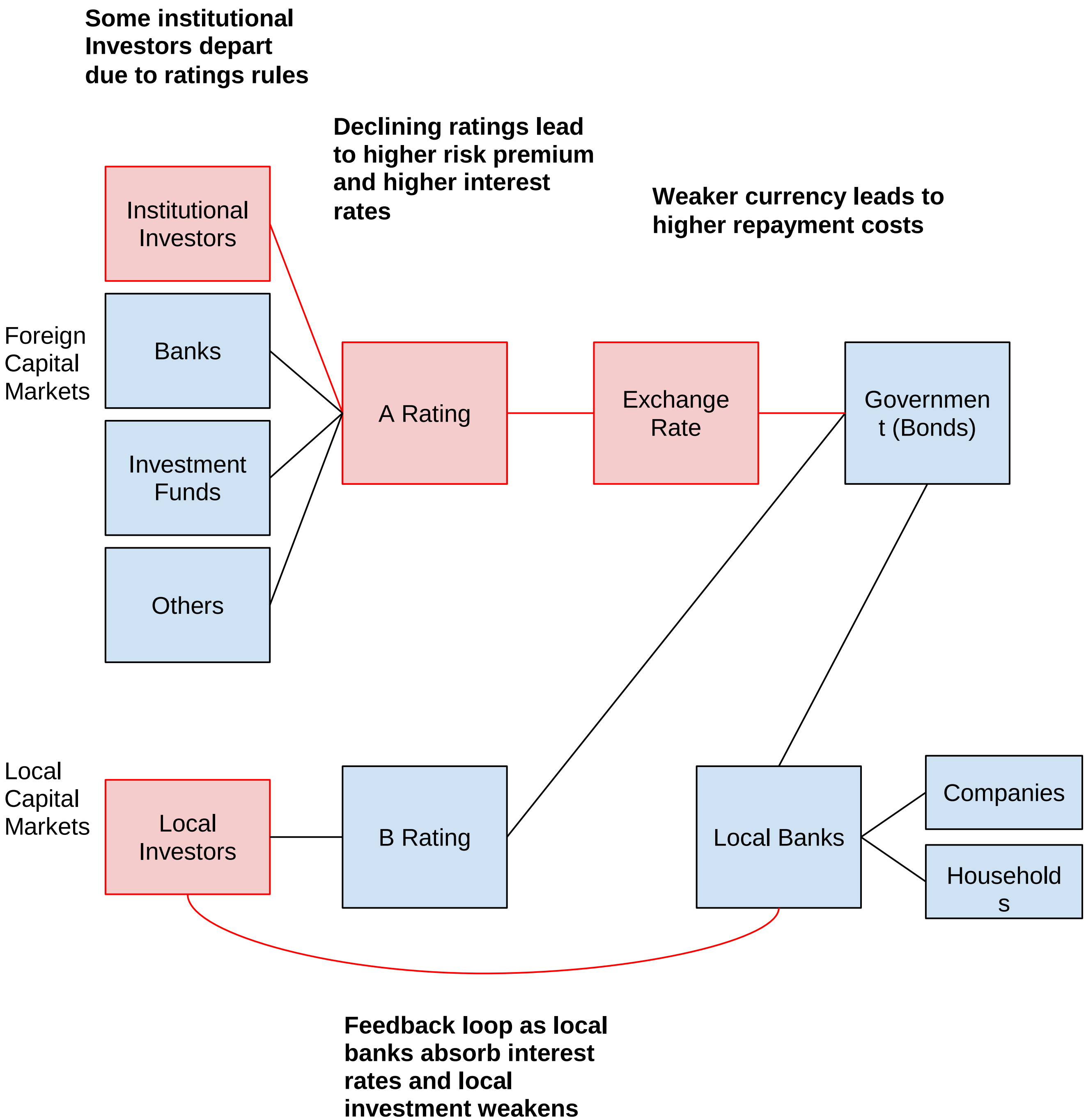
Countries Downgraded to Junk Status	
Azerbaijan	Korea
Brazil	Latvia
Bulgaria	Portugal
Colombia	Romania
Croatia	Russia
Egypt	Slovenia

Greece	Thailand
Hungary	Tunisia
India	Uruguay
Ireland	

It is important to understand precisely what the role of credit rating agencies is. Credit rating agencies help individual and institutional investors (pension funds etc) to determine whether issues of debt obligation (bonds and securities) will be able to meet their obligations with regards to security or debt instruments. This includes companies, municipalities, state-owned enterprises, and central governments. In short, sovereign ratings determine how risky it is to lend money to a government. More risky loans demand a higher rate of return, meaning the interest paid on government debt should increase to reflect the risk profile. In addition, a number of large institutional investors, like investment funds or retirement funds, will no longer be willing to lend to the country. Some of these investors are not allowed to hold investments in countries or entities that are sub-investment grade (junk), and as such are obligated to pull their money out. With fewer investors willing to lend, this should again drive up the interest rate paid by government. A weakening investment environment will in turn affect the exchange rate adversely, triggering a secondary impact that is diffused through the currency, namely the mounting of the cost of foreign borrowing. In addition, domestic borrowing is likely to weaken as banks and other financial institutions will find their access to capital markets constrained. The net result boils down to higher borrowing costs for government. The South African government already pays out 13% of its total revenue in debt repayments, as can be seen in Figure 1. This is likely to increase, eroding much resources for financing public service delivery, infrastructure development, and throttle public service wage bill.



The likely impact of all of this can be found in Figure 2.



The real-life impact of a downgrade can be a lot more complex. For starters, South Africa's downgrade is not as simple as a move from investment to junk status across the board.

All the downgrades thus far have been on the country's foreign debt, with local borrowing yet to feel the impact. South Africa borrows 90% of its debt in local currency, and while some of this will be impacted by the downgrade, the legacy of efforts to restructure South African debt has protected the country from some of the shock. Similarly, much of the impact of the change had already been priced-in by the markets, with their expectations of looming change softening the blow when that change finally arrived. The extent to which these factors soften the blow are unknown, and will be seen in the coming months.

As worrying as this direct impact on government borrowing is, there are a number of spillover impacts, of which three are most important. First is the likelihood of borrowing costs increasing for everyone, indirectly through the changes to the ratings. While there isn't a mechanical link between the sovereign downgrade and private borrowing costs, the sovereign ratings tend to act as proxy for political risk when assessing loans to major South African-based firms. While it's hard to understand the extent to which this might happen in this case, there is empirical evidence to suggest it might very well happen. Some of this has already been felt, with the major South African banks all being downgraded by Fitch directly after the sovereign downgrade. Banks are the transmission mechanism by which financial changes impact the real economy, and their downgrade is a clear sign that spillover impacts are on their way – and they could be worse.

Second, the downgrade may trigger changes in interest rates by the Reserve Bank. Again, this is an indirect impact, of which the most likely mechanism will be through the exchange rate. The exchange rate weakened substantially as an immediate reaction to the downgrade, albeit not as sharply as some expected, since the currency was already relatively slack. But the more lasting impact is likely to be on the average exchange rate, which will fall under increasing pressure from the weaker ability of the country to attract finance from skeptical foreign investors. The weakening of the exchange rate may encourage the Reserve Bank to raise interest rates to hold off potential inflationary pressures and to rebalance the exchange rate by attracting more investment into the country.

The extent to which all this will play out is in question - most of these effects are established in theory but far more complex in reality - but if they do, then the most likely reaction will be higher interest rates that further tax a highly indebted South African economy.

Third, the downgrade may raise questions for state owned enterprises. While the SOEs are rated separately, they are intrinsically linked to the state in a number of ways, the most pressing being a number of sovereign guarantees that the Treasury has offered. The guarantees have already been a point of concern, with Moody's previously identifying it as a possible driver of a downgrade.[2] Guarantees effectively reflect a hidden debt, as any crisis in an SOE with guarantees would put a large debt burden on the Treasury. Minister Gigaba has pledged to make reform of the SOEs a key part of his agenda, but it's not clear how much willingness there will be for the SOEs to change and, most pressingly, whether the most serious guaranteed SOEs, Eskom, will be able to survive the political push for a costly nuclear deal.

The sum total of these impacts will be a government that is less able to service the needs of its people, companies less able to finance their investments or see out hard times, and people less able to access cost-effective debt in the case of an emergency. Critics will slam the ratings agencies as imperialist forces trying to dictate policy. But they're the agents of the people we borrow from in order to do the things we want our economy to do. The real economic impact cannot be dismissed by reference to cheap rhetoric. Governments can take a hit like this if it means adopting new and visionary policies, but the President has repeatedly stressed that nothing is going to change, and thus there is no upside to compensate for the troubles. There is no positive story from the ratings downgrade.

Impact of the Reshuffle

While the downgrade was the most visible immediate impact of the reshuffle, more serious questions need to be asked about the potential impact of the reshuffle itself. Of course, there are some immediate issues that are of concern.

[2] http://www.fin24.com/Budget/BudgetReaction/moodys-flags-govts-debt-guarantees-as-a-risk-20170223

First is the impact the change may have on key initiatives, such as the nuclear energy procurement. While the issue remains clouded in uncertainty, especially after the Western Cape High court judgement on the legality of the calls for proposals that were issued by Eskom, the general understanding is that finance minister Pravin Gordhan strenuously opposed the deal, and that new minister Malusi Gigaba may be more open to taking this deal further if political pressure is brought to bear upon him. The nuclear deal is dogged by accusations of corruption and misdoings, including rumours that the deal was promised to Russia before due procurement processes were undertaken.

But the more fundamental concerns with the deal, if it were to go ahead, is with its very rationale in the context of South Africa's fiscal and energy future. Critics of the nuclear deal tend to argue that nuclear is an outdated technology, and a poor path to take given the increasing efficiency of renewable energy, which is cheaper to develop and growing in output. The specific criticism is open for debate, given that renewables are still an unpredictable source of energy (interrupted by weather and nights), and nuclear remains a low emission option for sustainable base load energy. But two other critiques are far more pressing.

First is that nuclear is simply too massive a cost for the Treasury to bare. Even if generous financing conditions were to come through, and the costs were put off for a number of years, the liability would still large. Estimates vary widely, ranging from $400 million, to a midpoint of $50 billion, and a high estimate of a trillion dollars.[3] Second, and most pressing, there's simply no clear reason why a massive nuclear energy plant is needed. Loadshedding may be scarred into the public consciousness of South Africa, but since 2015 energy demand has actually been in decline.[4] With large users like the steel industry either converting to alternative smelter technologies (like gas) or going under, and with a range of energy efficiency programmes being rolled out, energy has been in decline and may be increasingly delinked from economic growth.

[3] https://mg.co.za/article/2016-05-13-00-go-figure-nuclear-will-cost-sa-just-1-bn
[4] https://www.dailymaverick.co.za/article/2015-11-15-eskom-from-a-crisis-of-capacity-to-a-crisis-of-rising-prices-declining-demand-and-funding/#.WQOvvvR97rc

And with two of the world's largest coal plants at Medupi and Kusile still coming online, there simply isn't the need for that level of investment in a massive single project.

For all the legitimate concerns around the project, the decision on the nuclear deal has received undue focus, but it is particularly symbolic of a broader creeping undermining of strategic decision making under the administration of President Zuma, and a deeper erosion of key institutions.

Impact on the Public Sector

The extensive disruption caused by both the reshuffle and the downgrade cast into sharp light the upcoming expiration of the last public sector wage agreement. The negotiations will of course proceed as usual, albeit with a new Minister and a realigned Treasury. It is difficult to know how these changes in personnel will impact the negotiations. It takes a long time to prepare for negotiations. Trust has to be built between the negotiating parties. The National Treasury and the DPSA require a greater degree of understanding of their negotiating redlines in view of fiscal reality, and labour in particular want to get a sense that government negotiators are serious interlocutors who understand the business. Already by now there should be confidence building pre-negotiation talks in order for the different actors to start getting an understanding of where they come from, and what they likely approach will be. More importantly labour should be taken into confidence regarding the economic realities, the fiscal position, and the thinking of the National Treasury on addressing macro-economic challenges.

The relationship between other public sector unions and the current administration is currently strained. Some unions have made very strong political calls for the president to resign, and others have already announced that they would not negotiate with Minister Faith Muthambi. All of this takes the attention away from exploring the solutions needed to ensure a successful settlement by 31 March 2018.

But more concerning is the fiscal context facing the public sector. The Treasury has consistently argued for smaller increases in public sector wages and benefits, pointing to the increasingly constrained budget. When the current settlement was negotiated, Minister Nhlanhla Nene was at the helm at the National Treasury. He had cast down a fiscal redline around CPI Index. Although inroads were made, there was unfinished business related to various benefits that unions had made reasonable demands for. Given the current economic climate, and the fact that unions will regard government priorities especially with respect to state-owned enterprises as misplaced, the negotiations will be fraught. As the Public Servants Association, we have a mandate to defend the economic interest of our members, especially because the economic strain will be very unforgiving for them, and many of them support large households that count amongst them the unemployed. Many of our members are likely to be affected by interest rate hikes, and the general increase in the cost of living. The PSA have already declared intentions to seek an above-inflation increase in public sector wages, with Nehawu calling a 6.5% increase a "poverty wage."[5]

On balance, there are three potential scenarios for the upcoming talks, in light of the changes.

First, is a **high road** scenario. In this scenario, an administration shaken by the downgrade and endless accusations and scandals feels that they don't have the political weight to put up much of a fight in the negotiations. In this scenario, the administration is concerned that losing the support of the public-sector workers during a long and acrimonious negotiation could further undermine their capacity to function optimally. Political leaders, with an eye to the upcoming party electoral conference add to this concern. The net result is a relatively easy negotiation, in which public sector unions get most of what they want. This could be a positive outcome for the public sector in the short-term, but would raise concerns in the long-run.

[5] https://www.moneyweb.co.za/news/south-africa/major-union-to-seek-above-inflation-wage-hikes-raising-strike-risk/

A very large package awarded by a weakened government would undermine future talks, particularly with a new administration expected in two years' time. At that point, the new administration may be burdened with even more constrained state expenses, not from the negotiations but from an altered willingness to increase spending, which will constrain future administrations. The long-run health of public sector wages is closely intertwined with the health of public finances, and even this short-term result would not mean long-term stability.

Second, and the other extreme, is a route leading to **gridlock**. In this scenario, government's ever shrinking resources undermine the ability to reach compromise with public sector unions. Higher borrowing costs from the downgrade combine with increased pressure on the Treasury to spend big on projects like the nuclear deal. Meanwhile, the voice of ratings agencies grows even stronger, as government scrambles to hold off a deeper downgrade that would preclude efforts to recover. Tax revenues are likely to remain depressed, with both the institutional crisis at the South African Revenue Services and the weak economic environment leading to a plateau in the earnings that are needed to keep the budget on track. With the finance minister having no room to maneuver, but coming under ever more pressure, he could easily go on the defensive in the talks. Minister Muthambi, meanwhile, is unproven in such a situation, and he influence relative to the Treasury remains unknown. What is known is that Minister Muthambi has a proven track record of lashing out at those who oppose her or the President, and inflammatory rhetoric could feature strongly, particularly against a group of unions that have already come out against her appointment. If the rand is still weak, inflation could be forced upwards, placing public servants in a position where they feel the need to demand substantial increases. With the two sides intractably far apart, talks could easily break down into significant industrial action and an uncertain future.

The third scenario, and the one that seems most likely, is a continuation of the difficult **status quo.** Many of the issues faced by the Treasury (very little fiscal space), the Department of Public Service (instability at all levels of the department), and the public-sector unions (strained by fraying union alliances) were already in place or emerging during the last round of talks.

Those talks were acrimonious without being dangerously hostile, but all the problems are getting worse, and the result is likely to be an edging along the lines of the balance towards more serious conflict. Regardless, the government has no room to resist public servants demands forever, and unions seem to have enough room for bringing in benefits issues like child care or housing allowances to bridge the gap between the two sides. While this stumbling along is not particularly attractive for either side, it does have a certain sense of appeal, especially if there is openness on the side of government to resolving some of the historical issues related to benefits.

Conclusion

If anything, the reaction to the reshuffle is emblematic of a country that expects too little from our leaders. In the depth of outrage over the reshuffle and downgrade, simple questions of basic competence in decision making have been missed. The President made a decision with far reaching consequence for the whole country, and yet never provided a justification for why. An interested observer as much as a dedicated public servant would struggle to see where policies come from. There are strong arguments both for and against divisive issues like supporting SOEs, developing nuclear energy, or promoting local artists at the SABC. And yet the state seems completely disinterested in doing the hard work of justifying their positions or embracing the inevitable reality of trade-offs and costs that must be managed by any policy. Politics and the public service will always be divided on beliefs about how to drive the country forward. The true threat is when the mechanisms by which we make good decisions are discarded and torn apart. The hollow state of political thought and debate offers no reassurance that the country can be moved forward. And in the space of that clear decision making processes, it is inevitable that people view the motivations of the state are informed by corruption and cronyism.

In the short-term, the county and government will stumble on. The Treasury will keep working, public service talks will be overcome.

But shuffling around with our backs turned towards the injustices and suffering faced by too many in our country is a betrayal as deep as outright state capture. It's time to transform our expectations of our national leaders. Unaccountable reshuffles do not represent crossing a line, they represent a depth so far from the line as to blind us to systemic failure of the most vulnerable in the country. Change is needed.