Bank’s downgrading

“Do not kill a goose that is laying on golden eggs”

Recently, ratings agency Moody's downgraded South Africa's top five commercial banks to one notch above sub-investment grade, along with the Industrial Development Corporation of South Africa and the Land Bank.

Moody's mooted that the primary reason for the downgrading was weakening credit and the macro profile of the South African government, which exerts pressure on banks leading to challenging operating environment characterized by a pronounced economic slowdown.

This follows a decision by the same Moody's to downgrade South Africa's sovereign rating, stating the following three key drivers for the downgrade:

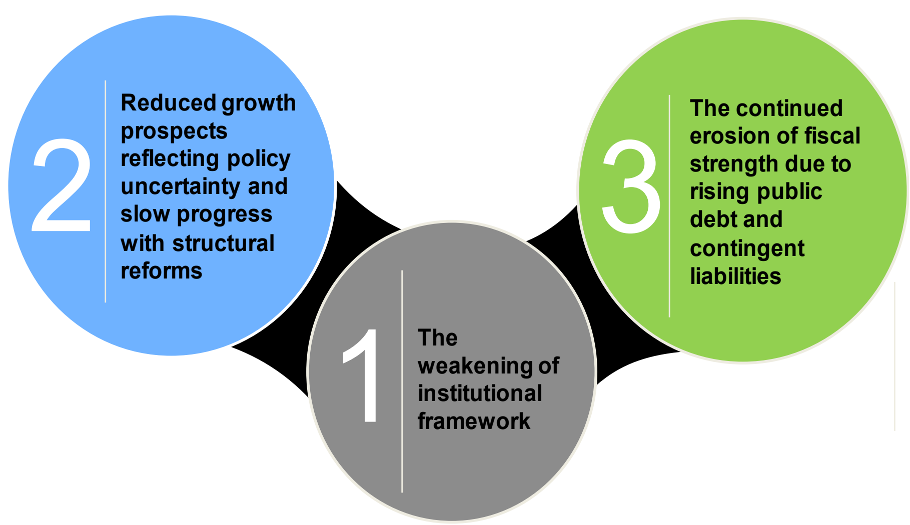

Figure 1: Moody's reasons for downgrading (1 – 3)

This confirms that the policy uncertainty and lack of strong economic and political leadership, which has triggered an unstable political environment are posing as threat to the economy.

Moreover, uncertainty over policy priorities has damaged investor confidence, reducing investment in the country's economy, which is already sitting on a technical recession after two straight quarters of negative growth as show by the **red line on chart 1.**

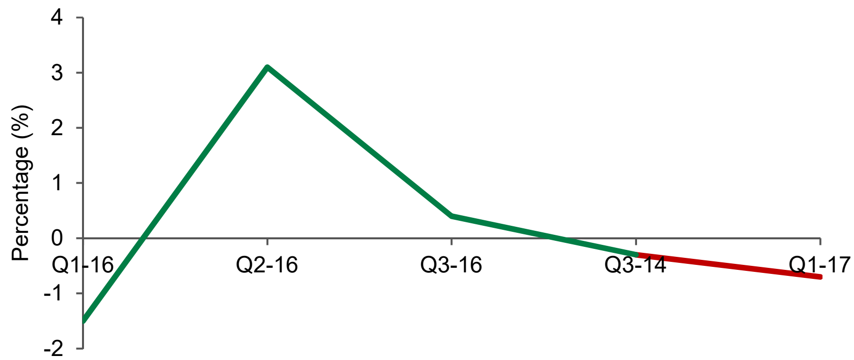

Chart 1: Growth in gross domestic product (%)
Data source: Stats SA

The credit rating downgrades of South African banks will invariably lead to higher prime interest rate and ultimately higher cost of credit. This means it will now be more expensive for banks to borrow money and that may get passed on to consumers in the form of higher interest rates and/or bank fees. This will have huge knock on effect on the ways consumers and business can access credit to make purchases and plan their finances.

While it is still early days to clearly tell how the markets will respond to the bank's downgrade, the current high levels of debt in the country and by the country (government in particular) and of course other issues that have been mentioned earlier are creating risk for South Africa's economy and that is being noticed beyond the country's borders.

Given that farmers rely on financing from commercial banks and some from the Land Bank, the recent credit downgrading of these banks will have an adverse impact on the recovery of the sector, particularly from the recent devastating drought that saw both productivity and profitability of farmers and agribusinesses come under enormous pressure in the past production cycles.

Chart 2 shows that within the agricultural sector, commercial banks and the Land Bank are the largest financiers constituting 53% and 30% of sources of credit for South African farmers respectively. Agricultural cooperatives constitute 9% of the source of credit for South African farmers.

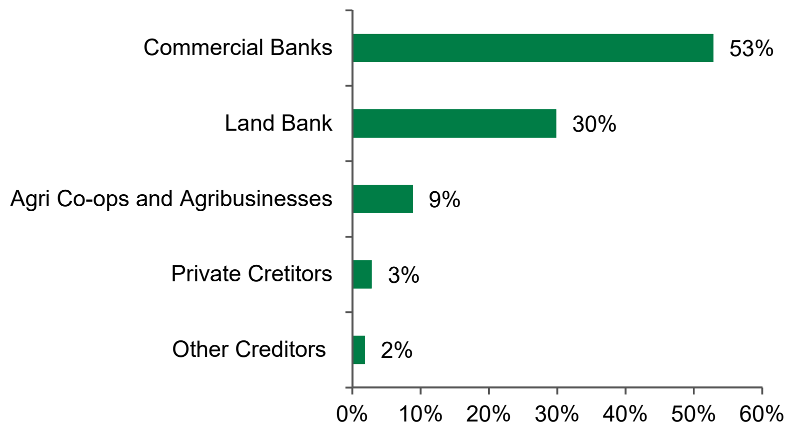

Chart 2: Source of credit for the agricultural sector
Data source: DAFF

Important to note is that prime interest charged by these financiers has been on the rise since 2014 after dropping to an average of 8,35 in 2013 **(see chart 3)**. In 2016, the prime interest rate charged by the commercial banks, agricultural cooperatives and the Land Bank averaged at 10,5%. This is likely to increase further at the backdrop of banks' credit downgrading.

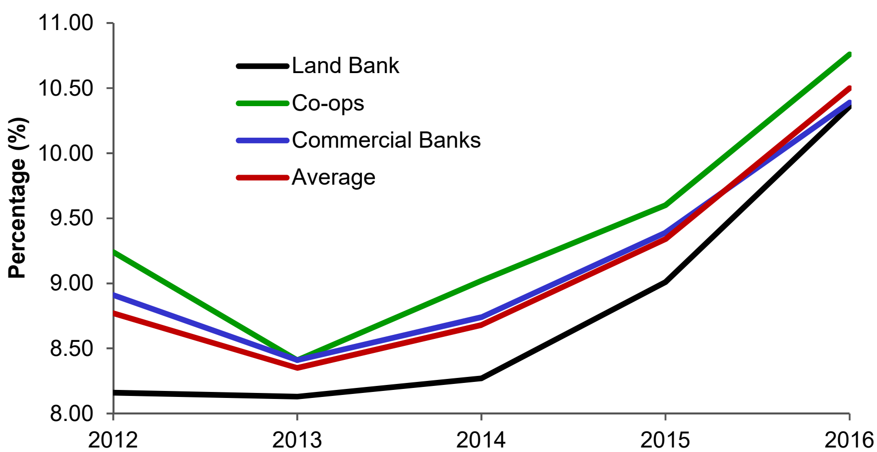

Chart 3: Prime interest charged by financiers from farmers
Data source: DAFF

During the previous Monitory Policy Committee (MPC) meetings of the Reserve Bank (SARB), an interest rate cut was signaled amid significant easing of inflation. However, given the economic turmoil the country is going through currently, the MPC reconsidered and concluded that it would be too risky to cut rates at this stage.

In addition, given South Africa's increasing international volatility as a result of credit downgrading, the SARB has to practice a greater level of caution in how it adjusts interest rate.

It is not unique to South Africa, that despite the declining inflation, the central bank of a country decides to hike interest rates. Recently in the United States of America, the Federal Reserve Bank approved yet another interest rate hike for 2017 even amid expectations that inflation is running well below the central bank's target. This is the second interest rate hike this year by the Federal Reserve Bank following the last increase in March 2017. Policy makers project that there could be one more hikes this year in the United States of America.

Usually, when the Federal Reserve Bank hikes interest rate it is an indication of how other central banks around the world will adjust theirs especially in emerging markets like South Africa. However, the reasons behind the adjustments may differ quite significantly. Sometimes when the economy is growing at a rate that is believed to be too fast, the central bank (in the case of South Africa, the SARB) may respond by raising interest rate to curb spending and encourage savings.

Another reason that may force any central bank to increase interest rate relates to the local currency fluctuations in the global market usually due to domestic factors such as, commodity prices and other economic related variables, the political environment, policy uncertainties, social unrests and other international factors. Domestic factors, particularly the unstable political environment have a significant impact on how the local currency performs in relation to other currencies in the market **(see chart 4)**.

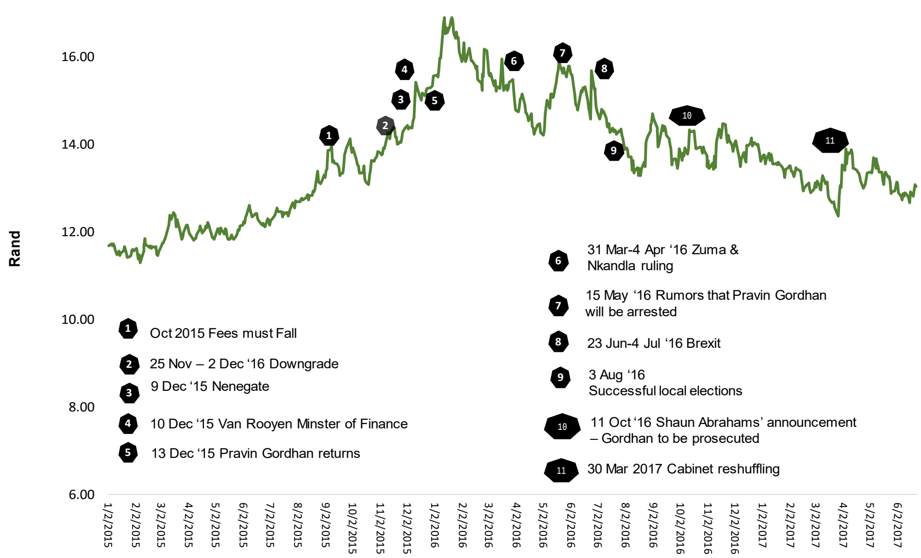

Chart 4: ZAR's fluctuations (January 2015- June 2017)

Just as an example to drive the point mentioned above, since the firing of former finance minister Nhlanhla Nene on 19 December 2015, the rand has struggled to get below the $12 mark. The Nenegate as it is known landed South Africa on the biggest financial crisis it has experienced since the advent of democracy. The same trend was witnessed when there were rumors that former minister of finance Pravin Gordhan would be arrested on 15 May 2016 and when there was a cabinet reshuffle on 30 March 2017.

While a weaker rand might benefit exports, it leads to an increase in the cost of imported agricultural inputs particularly chemicals, fertilizer, and fuel. Also, given that domestic grain prices are derived from international prices, a sustained weak rand will fuel consumer inflation thereby eroding the purchasing power. When this happens the SARB may in turn be forced to delay interest rate cuts or even to increase them.

During the MPC meetings dated 23-25 May 2017, the SARB decided to keep rates on hold at 7%. This is highly unlikely to happen during the next MPC meeting scheduled for 18-20 July 2017.

It has already been noted, that the agricultural sector has shown strong resilience and contributed positively to the gross domestic product (GDP) in the first quarter of 2017 despite poor production output in the Western Cape. The contribution was primarily driven by forestry and horticulture products, particularly the fruit exports. In addition, the sector's outlook for the current season is showing positive signs driven by a robust recovery in the agricultural production side, particularly that of the summer grains and oilseeds.

In my previously writing, I have recommended that agricultural development must be made a national priority because agriculture is an area of growth, and it plays a crucial role in the broader economy. Just on the employment side, agriculture constitutes about 5% of the country's labour force. This is double the contribution by the mining sector and is almost in par with the transport sector.

While the players in the agricultural sector celebrate the recovery of the sector from the recent drought and the contribution the sector has made to the GDP in recent times, the increased borrowing costs as a result of credit rating downgrades will have huge knock on effects on the farmers' ability to access and to repay credit.

Chart 5, shows that over the past 9 to 10 years, the South African agricultural sector's debt has risen exponentially and is expected to worsen on the backdrop of the country's banks' credit downgrading. In 2016, the sector's debt increased by 9% (y/y) to over R144 billion.

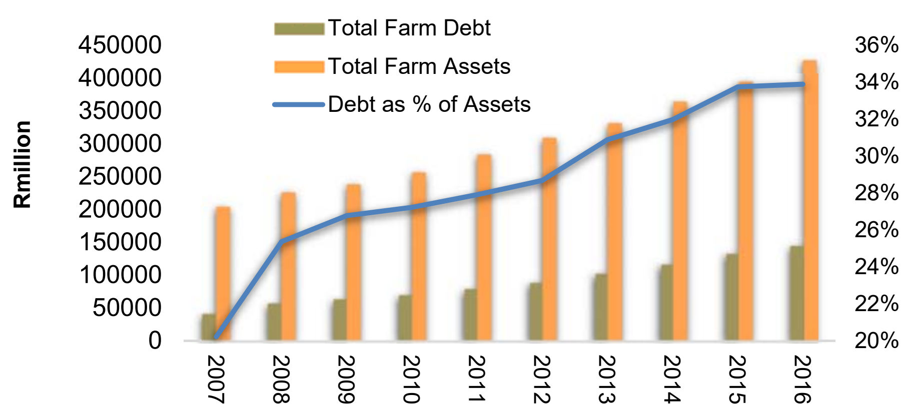

Chart 5: Agricultural debt, farm assets and debt as % of assets
Data source: DAFF

DOWNGRADING

The bank’s downgrading implies that banks will revise their pricing model for both individuals and businesses including farming businesses. Consequently, this will increase further the current debt of farmers and ultimately weaken their financial position and probably delay or reduce investment in the sector.

Notwithstanding the above mentioned adverse impact pertaining to the sector’s debt levels, the bank’s downgrading could also result in a reduction in the employment levels in the sector. In this regards it is important to note that farming businesses operate differently compared to the normal businesses.

Farmers usually don’t have funds readily available for the day-to-day operating expenses on the farm. They must first cultivate the soil, put the crop on the ground, let it grow, harvest it and sell it to the market - only then will they receive their income. Before then, they rely of banks to finance their running cost which salaries form a larger component of. At significantly higher interest rate, farmers might not afford the same levels of credit and that will have an adverse impact on the day-to-day operations on the farm.

The biggest concern regarding banks credit downgrading is that it is likely to reverse the positive impact on the recovery of the sector for the next production cycles. The agricultural sector has a fundamental responsibility in the economy. It must ensure that the nation is food secure. It must contribute towards employment creation and to the GDP growth. All this cannot happen unless the sector’s allowed the space to operate effectively and profitable.

Finally, the problems that the country is facing, be it the downgrading, the lower investment confidence, the high levels of unemployment and ultimately slow economic growth are all self-inflicted.

Ministers that have been tasked with the responsivity of ensuring that South Africa prospers in every aspect, are instead busy making irresponsible pronouncements on issues that do not fall within their ministry such as saying, “*let the rand fall, we will catch it*”. Such irresponsible statements are damaging to the economy.

On the other hand, we have people heading our chapter nine institutions like the public protector that are interfering on issues that are outside their mandate and neglecting their call of duty to investigate acts of corruption, which are sending South Africa on a downwards spiral.

All these issues are significantly impacting negative on South Africa's ability to grow and they are also being noticed outside the country's borders. Much more needs to be done speedily to bring back stability in the country and to restore investor confidence. Perhaps the policy conference of the ANC on Friday, 30 June 2017, will provide an indication as to whether South Africa will be steered in towards economic recovery going forward.

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