What does the recent downgrade to sub-investment grade mean for SA agriculture?

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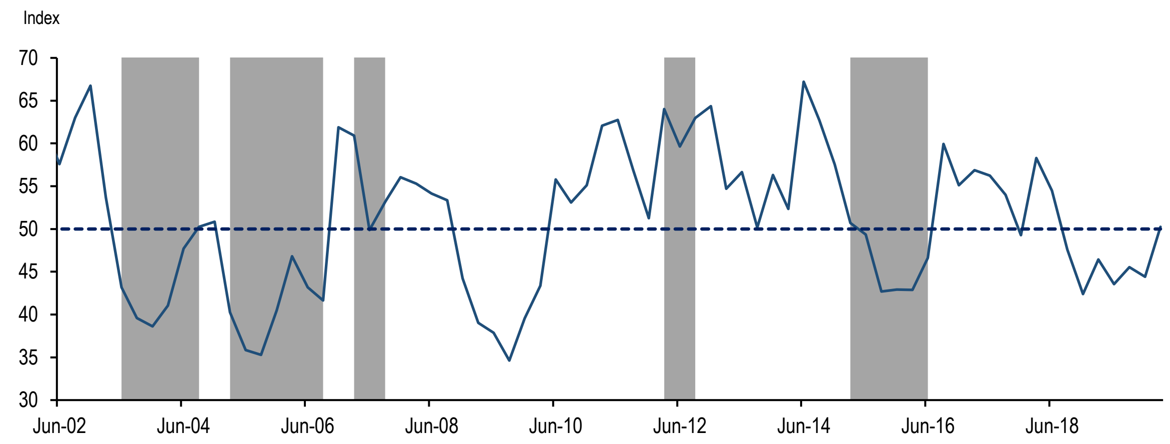
On 27 March 2020, Moody's downgraded South Africa's sovereign credit rating to sub-investment grade and placed a negative outlook on the rating. The key drivers for this downgrade include weak economic growth, continuing deterioration in fiscal strength, and slow progress on structural economic reforms. It is now the first time in post-apartheid South Africa where all major rating agencies, i.e. Moody's, Fitch and S&P, have South Africa's credit ratings in sub-investment grade territory. The key question some might be asking is what this means for South Africa's agriculture?

There could be various transmission channels, but we believe that there are three major ones in the near terms. First, there could be a deterioration in confidence levels in the agricultural and agribusiness sectors, and thereafter investment. We gauge confidence in the agricultural and agribusiness sector through the Agbiz/IDC Agribusiness Confidence Index (ACI), which in the first quarter of this year improved by 6 points to the neutral 50-point mark. This slight improvement was underpinned by improved agricultural conditions across the country following good rains. The ACI comprises of 10 subindices, of which two are economic conditions in the country and capital investment. [1]

Exhibit 1: Agbiz/IDC Agribusiness Confidence Index



Source: Agbiz Research, South African Weather Service
(Shaded areas indicate periods when rainfall across South Africa was below the average level of 500 millimetres)

With economic conditions have deteriorated in the country further due to the spread of COVID-19 and measures put in place to contain the virus, the confidence levels could deteriorate in this particular subindex in the coming quarters. The sentiment regarding the capital investment subindex could also show deteriorate in the coming quarters amid the recent downgrade by Moody's. Ultimately, this will be a drag on the ACI, and possibly investment levels in agriculture. Such a scenario would be a setback to the government and the private sector's goal of ensuring that South Africa's

[1] The Agbiz/IDC Agribusiness Confidence Index reflects the perceptions of at least 25 agribusiness decision-makers on the 10 most important aspects influencing a business in the agricultural sector (i.e. turnover, net operating income, market share, employment, capital investment, export volumes, economic growth, general agricultural conditions, debtor provision for bad debt and financing cost).

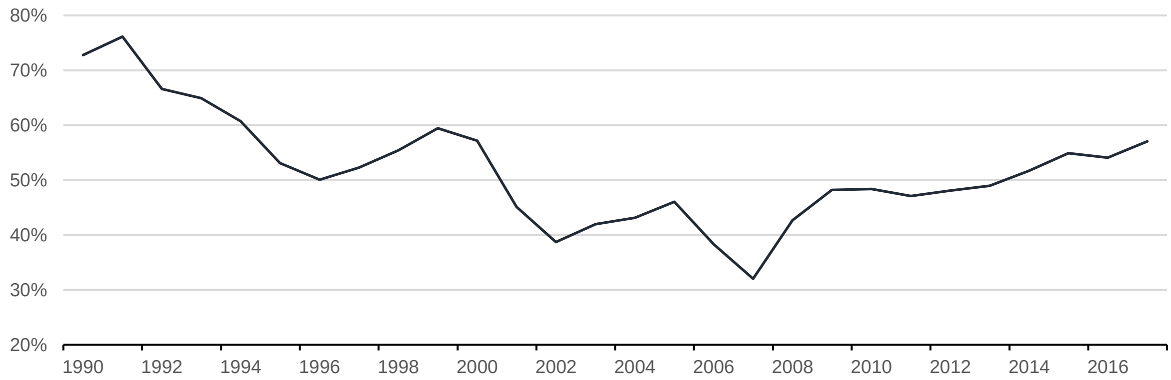
agriculture is amongst the sectors that drive the economic growth and bring much-needed employment in the rural areas.

Second, the volatility of the domestic currency could be another transmission of the effects of a sub-investment grade into agriculture. This would particularly be felt through the cost of inputs. South Africa imports roughly 80% of its fertilizer, 99% of active ingredients of agrochemicals, agricultural equipment and fuel. The cost of these inputs could be affected by the weaker domestic currency. So far, however, the lower oil prices have played a buffer to what could have potentially be a steep increase in fuel and fertilizer prices.

Third, there could also be a credit impact. Ordinarily, a credit rating downgrade to a sub-investment level would be felt through the rise in a cost of capital as the SARB would likely lift the interest rates in response to possible exchange rate depreciation and associated inflation risks. But this time is slightly different. The COVID-19 pandemic has disrupted the global supply chains, which subsequently led to deteriorating economic conditions. Several central banks, including the South African Reserve Bank, have responded by reducing interest rates as a way to ease financial conditions. This means the cost of capital has somewhat been reduced amid COVID-19. The transmission of a sub-investment grade could now be through the scarcity of capital. It is plausible to think that some financial institutions could become more risk-averse to lending, especially to already highly indebted farmers.

South Africa's farming sector is heavily in debt. As of 2018, the total farm debt was at record R168 billion. About 60% of the debt is with the commercial banks, 29% is with the Land Bank, with the rest spread between agricultural cooperatives, private persons and other institutions. The escalation of debt, particularly in more recent years, was because of both the expansion in area farmed, specifically in horticulture and to some extent, the financial pressure brought by frequent droughts, which have limited agricultural output on various farms over the recent past.

Exhibit 2: South Africa's farm debt as a percentage of the agricultural gross value added



Source: DAFF, Agbiz Research

Policy considerations

While the response to deteriorating credit ratings will largely be macroeconomic and specifically fiscal, what the agricultural sector could focus on is:

- To ensure continuous adoption of climate-smart farming techniques and other technologies that help the sector adapt to the changing climatic conditions.

- The uncertainty over property rights was noted by Moody's as one of the key risks on South Africa. To this end, the outcome of the land reform policy discussions about Section 25 of the Constitution, which entails property rights, is an important event to look out for when Parliament resumes, which we suspect will be after COVID-19 pandemic. This will be an important determinant of the direction that South Africa's agricultural sector will be taking. Ultimately, South Africa's agricultural sector is capital intensive, any policy that does not encourage investments into the sector will lead to the deterioration of agricultural fortunes. There are various proposals of accelerating land reform without undermining property rights which some are contained in the report of the Presidential Panel on Land Reform and Agriculture.[2]

[2] https://www.gov.za/sites/default/files/gcis_document/201907/panelreportlandreform_1.pdf