

Rating Action: Moody's downgrades South Africa's ratings to Ba1, maintains negative outlook

27 Mar 2020

Paris, March 27, 2020 -- Moody's Investors Service, ("Moody's") has today downgraded the Government of South Africa's long-term foreign-currency and local-currency issuer ratings to Ba1 from Baa3. The outlook remains negative.

The key driver behind the rating downgrade to Ba1 is the continuing deterioration in fiscal strength and structurally very weak growth, which Moody's does not expect current policy settings to address effectively. Both outcomes speak to weaker economic and fiscal policy effectiveness than Moody's previously assumed.

The negative outlook reflects the risk that economic growth will prove even weaker and the debt burden will rise even faster and further than currently expected, weakening debt affordability and potentially, access to funding.

Moody's also downgraded South Africa's long-term foreign-currency and local-currency senior unsecured debt ratings to Ba1 from Baa3, its foreign-currency senior unsecured MTN and senior unsecured Shelf ratings to (P)Ba1 from (P)Baa3, as well as its foreign-currency other short-term rating to (P)NP from (P)P-3.

In a related action, Moody's downgraded ZAR Sovereign Capital Fund Propriety Limited's foreign currency, backed senior unsecured debt rating to Ba1 from Baa3 and maintained its negative outlook. ZAR Sovereign Capital Fund Propriety Limited is a special purpose vehicle whose debt issuance is ultimately the obligation of the South African government.

All South Africa's long-term country risk ceilings were revised down by one notch. Its long-term local-currency bond and bank deposits ceilings were revised down to A3 from A2, and the long-term foreign-currency bond ceilings to Baa1 from A3. The short-term bond foreign-currency ceiling remained unchanged at Prime-2. Moody's also lowered the long-term foreign-currency bank deposits ceilings to Ba1 from Baa3 and the short-term foreign-currency bank deposits ceiling to Not Prime(NP) from Prime-3.

RATINGS RATIONALE

RATIONALE FOR THE RATING DOWNGRADE TO Ba1

STRUCTURALLY VERY WEAK GROWTH AND CONSTRAINED CAPACITY TO STIMULATE THE ECONOMY

Unreliable electricity supply, persistent weak business confidence and investment as well as long-standing structural labour market rigidities continue to constrain South Africa's economic growth. As a result, South Africa is entering a period of much lower global growth in an economically vulnerable position. The government's own capacity to limit the economic deterioration, in the current shock and more durably is constrained. Fiscal space is very limited and looser monetary policy will not address underlying structural problems. The unprecedented deterioration in the global economic outlook caused by the rapid spread of the coronavirus outbreak will exacerbate the South Africa's economic and fiscal challenges and will complicate the emergence of effective policy responses.

Progress on structural economic reforms has been very limited. Some initiatives to improve competition and encourage job creation have progressed, but none that constitute a step-change for the economy. Structural issues such as labour market rigidities and uncertainty over property rights generated by the planned land reform remain unaddressed. Moreover, a strategy to stabilize electricity production has been slow to emerge and has yet to prove its effectiveness. Moody's assumes that while power supply will become more reliable, the restoration of full capacity will take some years to complete. As a result, after the immediate sharp downturn, growth will remain very low in the following years.

INEXORABLE RISE IN GOVERNMENT DEBT OVER THE MEDIUM TERM

South Africa's debt burden will rise over the next five years under any plausible economic and fiscal scenario.

Debt-to-GDP increased by 10 percentage points (ppts) over 2014-18 and will rise by a further 22 ppts over 2019-23 under Moody's baseline projections. Over that timeframe, Moody's expects primary deficits to persist. The fiscal deficit will widen in fiscal 2020 to around 8.5% of GDP, as revenue declines this year, only narrowing very gradually thereafter. Fiscal strains from interest payments and support to state-owned enterprises will continue.

In this context, and consistent with the recently announced budget, any fiscal consolidation will rest primarily on containing the large and growing public sector wage bill. The government aims to achieve ZAR160 billion (3% of GDP) in savings over the next three fiscal years by keeping wage growth below inflation. That would mark a material departure from current agreements and past outcomes, and as such is likely to prove challenging to implement. Moody's expects expenditure on wages to exceed budget at least in 2020.

Interest rates are likely to rise above the levels assumed in the budget and nominal growth will be weaker. Moody's estimates that the debt burden will reach 91% of GDP by fiscal 2023, inclusive of the guarantees to state-owned enterprises from 69% at end of fiscal 2019. Even if the government's plans to restrain wage growth were fully implemented, debt-to-GDP would still continue to rise significantly. Similarly, even under a scenario of more effective improvement in tax compliance and falling interest rates from fiscal 2021, government debt would still rise to around 87% by 2023.

RATIONALE FOR THE NEGATIVE OUTLOOK

The negative outlook reflects downside risks around economic growth and fiscal metrics, that could lead to an even more rapid and sizeable increase in the debt burden, further lowering debt affordability and potentially weakening South Africa's access to funding.

Downside risks to growth are both immediate and longer term, relating to heightened uncertainty about the economic impact of the coronavirus pandemic and to the possibility that negative economic sentiment becomes further entrenched as policymakers and stakeholders continue to struggle to reach consensus on the structural reforms that would sustainably stimulate growth and employment. With unemployment at already very high levels (29%), even weaker growth would have significantly negative social implications.

Should these downside risks materialise, South Africa's government debt would stabilise later and at a higher level than currently expected by Moody's. A steeper increase in debt would weaken debt affordability, potentially challenging the government's currently strong access to funding at manageable costs, particularly during periods of acute risk aversion by global investors such as at present. Although South Africa's exposure to global financing conditions is mitigated by its reliance on local currency debt, its weak economic and fiscal fundamentals could exacerbate adverse capital flows.

ENVIRONMENTAL, SOCIAL, GOVERNANCE CONSIDERATIONS

Environmental risk influences Moody's assessment of South Africa's economic resilience. Due to its geographical location, South Africa is subject to frequent climate change-related shocks such as droughts which undermine the agricultural sector's performance and weigh on growth. Set against that, the country's economic diversification and sophisticated agricultural techniques mitigate the impact of environmental considerations on South Africa's credit profile.

Social considerations are material for South Africa's credit profile and their implications for the economy and public finances are a driver of the rating downgrade. Deep socio-economic inequalities complicate the implementation of reforms that would otherwise unlock the economy's significant potential. They also contribute to tensions and resistance from key stakeholders that ultimately fuel political risk.

Governance considerations are material to South Africa's credit profile. South Africa's ranking under the Worldwide Governance Indicators is stronger than Ba1-rated sovereigns, and the strength of key institutions, in particular the South African Reserve Bank and the Treasury, support the rating. However, the broader erosion in institutional strength induced by the wide-spread corruption of the Zuma administration is an important factor behind the erosion in South Africa's credit profile in recent years. Moreover, the legacy that era has bequeathed of poor governance of state-owned enterprises remains a key drain on fiscal resources.

WHAT COULD CHANGE THE RATING UP

Given the negative outlook a rating upgrade is unlikely in the near future.

Moody's would likely change the rating outlook to stable if the government's medium-term fiscal consolidation were to proceed broadly in line with the rating agency's central expectations, with prospects of a slow but durable pick-up in growth and financing risks remaining low. In this scenario, Moody's would likely see a gradual reduction in South Africa's primary deficit in the next few years, with increasing assurance that government debt will stabilize comfortably below 90% of GDP.

WHAT COULD CHANGE THE RATING DOWN

South Africa's ratings would likely be downgraded if Moody's were to conclude that any combination of very weak growth, failure to reduce the primary deficit, and rising financing costs was likely to cause the debt burden to rise to even higher levels than currently projected with even greater uncertainty regarding its eventual stabilisation, in turn threatening South Africa's access to funding at manageable costs. Such an outcome would speak to weaker institutional policymaking capacity and, over time, a diminution of economic and fiscal strength consistent with lower rating levels.

Important indicators in this regard include the government's ability over the next year or so to contain the impact of global recession on the South African economy and to promote recovery thereafter; to agree and begin to implement the structural reforms that would strengthen the economy. The implementation of the framework for a reliable supply of power to the economy and fiscal reforms to contain expenditure and enhance revenues are important milestones.

NATIONAL SCALE RATINGS

Moody's will shortly publish an update to its National Scale Rating (NSR) map for South Africa to reflect the downgrade of the government's long-term issuer rating. Moody's NSRs are ordinal rankings of creditworthiness relative to other credits within a given country, which offer enhanced credit differentiation among local credits. NSRs are generated from Global Scale Ratings (GSRs) through correspondences, or maps, specific to each country. However, unlike GSRs, Moody's NSRs are not intended to rank credits across multiple countries. Instead, they provide a measure of relative creditworthiness within a single country. The full maps can be accessed through the "Index of Current and Superseded Compendia of National Scale Rating Maps by Country".

GDP per capita (PPP basis, US\$): 13,630 (2018 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 0.8% (2018 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 4.4% (2018 Actual)

Gen. Gov. Financial Balance/GDP: -4% (2018 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: -3.5% (2018 Actual) (also known as External Balance)

External debt/GDP: [not available]

Economic resiliency: baa2

Default history: At least one default event (on bonds and/or loans) has been recorded since 1983.

On 24 March 2020, a rating committee was called to discuss the rating of the South Africa, Government of. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have materially decreased. The issuer's institutions and governance strength, have not materially changed. The issuer's fiscal or financial strength, including its debt profile, has materially decreased. The issuer's susceptibility to event risks has not materially changed.

The principal methodology used in these ratings was Sovereign Ratings Methodology published in November 2019. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

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Lucie Villa
VP - Senior Credit Officer
Sovereign Risk Group
Moody's France SAS
96 Boulevard Haussmann
Paris 75008
France
JOURNALISTS: 44 20 7772 5456
Client Service: 44 20 7772 5454

Marie Diron
MD - Sovereign Risk
Sovereign Risk Group
JOURNALISTS: 852 3758 1350
Client Service: 852 3551 3077

Releasing Office:
Moody's France SAS
96 Boulevard Haussmann
Paris 75008
France
JOURNALISTS: 44 20 7772 5456
Client Service: 44 20 7772 5454



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