MOODY'S
INVESTORS SERVICE

Rating Action: Moody's confirms South Africa's Baa3 rating and changes the outlook to stable

Global Credit Research - 23 Mar 2018

London, 23 March 2018 -- Moody's Investors Service today confirmed the long-term issuer and senior unsecured ratings of the Government of South Africa at Baa3, as well as the (P)Baa3 senior unsecured shelf and senior unsecured MTN program ratings. The outlook was changed to stable. The rating actions conclude the review for downgrade that commenced on 24 November 2017.

The confirmation of South Africa's ratings reflects Moody's view that the previous weakening of South Africa's institutions will gradually reverse under a more transparent and predictable policy framework. The recovery of the country's institutions will, if sustained, gradually support a corresponding recovery in its economy, along with a stabilization of fiscal strength.

The stable outlook reflects a careful balance of risks. The new administration faces equally significant opportunities and challenges. Steady progress in meeting the objectives set out in the President's recent State of the Nation Address (SONA) will be needed if the recovery in confidence that will be essential for the country's economic and fiscal prospects is to be sustained. Success offers the prospect of a virtuous circle of economic recovery, fiscal consolidation and rising social cohesion. But the political, policy and practical challenges of meeting diverse economic, social and fiscal objectives cannot be underestimated. Failure, at least as perceived by investors or voters, could lead to a further cycle of eroding economic, fiscal and institutional strength.

In a related decision, Moody's confirmed the government's other short-term rating at (P)Prime-3. Moody's also confirmed the Baa3 backed senior unsecured debt issued by ZAR Sovereign Capital Fund Propriety Limited, a special purpose vehicle whose debt issuance is ultimately the obligation of the South African government, and changed the outlook to stable.

South Africa's long-term local-currency bond and bank deposits ceilings remain unchanged at A2, and the long-term and short-term foreign-currency bond ceilings are also unchanged at A3/Prime-2. The long-term foreign-currency bank deposits ceilings remain at Baa3, while the short-term foreign-currency bank deposits ceiling remains at Prime-3.

RATINGS RATIONALE

RATIONALE FOR CONFIRMING THE Baa3 AND (P)Prime-3 RATINGS

FIRST DRIVER -- HALT IN THE DETERIORATION OF SOUTH AFRICA'S INSTITUTIONAL FRAMEWORK, WITH LONG-STANDING STRENGTHS PRESERVED AND SOME REBUILDING OCCURRING

The recent change in political leadership appears to have halted the gradual erosion of the strength of South Africa's institutions. With changes in governance, a number of key institutions, including the Treasury, the South African Revenue Service (SARS) and key State-Owned Enterprises (SOEs) have embarked on the recovery of their earlier strength.

The technical strength and independence of South Africa's media, civil society and institutions, including key ministries, the Reserve Bank and the judiciary, have been critical in sustaining the country's credit profile over time. However, recent years have seen a gradual erosion in the strength of some key institutions, with a correspondingly negative impact on economic and fiscal strength and on the effectiveness of policymaking. High and rising concerns regarding endemic high-level corruption, 'state capture' and pressures on the mandate and independence of key policy-making institutions such as the Reserve Bank have materially damaged economic confidence and effective policy-making, exacerbating the erosion in the government's balance sheet.

Examples of the erosion of the government balance sheet are diverse, but include the increasingly entrenched financial challenges facing key SOEs, the decline in the capacity of SARS to collect revenue for the government and, most recently, the absence of any clear policy direction in the Medium Term Budget Policy

Statement (MTPBS) published in October 2017, a key driver of Moody's recent review of South Africa's credit rating.

The recent change in political leadership offers a real prospect of a decisive reversal in that erosion of strength. While it is still very early days, the speed with which the President has moved to replace the leadership in key institutions, including the Ministries of Finance, Mineral Resources and Public Enterprises and most recently in SARS, illustrates the resolve to address the problems of the recent past and to set the state, society and the economy on a new and positive path. At the same time, the ambitious reform agenda set out in the SONA illustrates an acknowledgement of, and the intent to address, the range and depth of South Africa's economic, fiscal and social problems.

SECOND DRIVER -- IMPROVED GROWTH PERFORMANCE AND PROSPECTS

The change in political leadership comes in parallel with growing signs of cyclical, and perhaps structural, improvements in economic growth.

2017 was the second year in a row when growth outturned higher than initially forecast. Even if the improvement was to a large extent cyclical, driven by external demand and by one-off factors such as the easing of the drought, the prospect of higher than expected growth this year and next allows the government some additional fiscal and political space in which to pursue reforms.

Moreover, the recovery in growth has been mirrored more recently by a sharp recovery in business and consumer confidence, illustrated both in surveys, and by other indicators such as the recent recovery in the value of the rand. While confidence can dissipate quickly, if sustained through further actions, it offers the prospect of rising levels of investment in South Africa's economy and enhanced medium-term growth.

The government recognizes the need to support improving confidence with steady progress on structural reform, including in the areas of mining, energy, the SOE sector and competition. Future growth prospects will inevitably reflect its progress in those areas. For now, though, the enhanced political and policy certainty ushered in by the recent changes offers some confidence that renewed business confidence will be sustained.

THIRD DRIVER -- FISCAL ADJUSTMENT PLANS THAT WOULD STABILIZE AND EVENTUALLY REDUCE THE DEBT BURDEN

In marked contrast to last October's MTPBS, the 2018 budget outlines a clear strategy for addressing rising fiscal pressures, with a front loaded, revenue-driven, fiscal adjustment, supported by material cuts in expenditures in this and subsequent years needed to finance, inter alia, rising expenditure on education.

The recently-announced one percentage point increase in VAT will broaden the fiscal policy response beyond the expenditure controls on which the government has increasingly relied in recent years. However, its significance goes beyond the moderate increase in revenues (of around Rand 22 billion) that the increase will allow. As the first increase in indirect taxes for over two decades, the change signals a marked, and credit positive, policy shift.

Overall, Moody's now expects the government's debt burden to stabilize at around 55% of GDP over the 2018-2020 period.

Significant uncertainties remain, and risks are tilted to the upside. Over the near-term, the departmental cuts required to support (inter alia) the increased spending on education announced under the previous Presidency will test policymakers and administrators alike. Hard political choices will arise; spending pressures from, for example, public wages and the cost of higher education, will persist. The still-fragile state of many SOEs, in particular Eskom Holdings SOC Limited, poses material contingent liabilities.

Set against that, a continued recovery in growth would boost revenues and provide further policy space.

RATIONALE FOR A STABLE OUTLOOK

The stable outlook balances upward and downward pressures.

Marshalled and developed by strong institutions pursuing an effective set of reforms and policies, South Africa's economy has significant growth potential. A combination of growth, expenditure restraint and further improvements in the breadth of the revenue base and in collection capacity should, if pursued effectively, lead to the debt trajectory stabilizing in the next two to three years and ultimately reversing. Incoming policymakers have emphasized their commitment to addressing risks to the debt trajectory growth emanating from the SOE sector.

However, the authority and capacity of the incoming administration remains to be fully tested. The divisions within the ANC, and more broadly within society, as illustrated by the increasingly pluralistic political environment, will present policymakers with diverse and sometimes conflicting political priorities which will create policy uncertainty. The policy agenda itself is broad and challenging, and contains elements that have the potential to create tensions within the administration and society.

Two immediate examples are the still-to-be-agreed Mining Charter and the land appropriation without compensation initiative. On the former, the President has emphasized his intention to balance the conflicting priorities of industry, unions and the broader goal to encourage black economic empowerment of the industrial base. Satisfactory progress in this area will be an important test of the ANC's authority and ability to reach the compromises needed to push through a broader reform agenda. Land appropriation is a long-standing objective of the ANC which has, for a number of reasons, assumed a higher profile in recent years. It remains unclear how the new government will pursue its objectives in this area, or what impact that will have on agricultural production and security. How the government acts will also provide important insights into how it plans to balance nearer-term economic objectives (to sustain confidence and promote investment) against longer-term social and economic objectives (to address unemployment, inequality and poverty).

In short, the outlook reflects two possible visions for the sovereign credit ratings: the first is a positive one in which a virtuous cycle emerges of economic growth, fiscal prudence and mounting social cohesion. The second is a more negative one in which policy ineffectiveness continues to undermine confidence, growth and social cohesion, with inevitable consequences for the government's balance sheet.

WHAT COULD CHANGE THE RATING -- UP

Future rating actions will most likely be driven by the effectiveness with which the government is able to address the institutional problems of the recent past in the pursuit of its economic and fiscal reform agenda.

The successful implementation of structural reforms to raise potential growth as well as stabilize and eventually reduce the debt burden, including through reforms to the SOE sector which reduce contingent liabilities, would put upward pressure on the rating. In particular, reforms resulting in higher savings and investment rates and broad-based, sustainable, job-creating growth, alongside rebuilding of fiscal buffers would provide positive momentum to the rating. In reaching such a conclusion, Moody's would consider the longer-term ramifications of near-term fiscal and economic outcomes, as well as progress in enacting reform measures and resolving long-standing structural issues, including those relating to mining and agriculture.

WHAT COULD CHANGE THE RATING -- DOWN

Conversely, South Africa's ratings would be placed on negative outlook or review for downgrade, and eventually downgraded if it were to become clear that the government's commitment to, or capacity to engineer, revived growth and debt stabilization were to falter. In reaching such a judgment, Moody's would consider the government's success in delivering planned structural reforms in the period between now and the 2019 Presidential elections, and to the impact of its actions or inaction on the investment climate and on near-term and potential growth. Negative developments in fiscal policy would also weigh on the rating. This includes the potential for SOE sector risks crystallizing in a manner which raised the government debt burden and put it on a higher trajectory.

GDP per capita (PPP basis, US$): 12,321 (2016 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 0.3% (2016 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 7.1% (2016 Actual)

Gen. Gov. Financial Balance/GDP: -2.5% (2016 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: -3.2% (2016 Actual) (also known as External Balance)

External debt/GDP: 52% (2016 actual)

Level of economic development: Moderate level of economic resilience

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