FITCH AFFIRMS SOUTH AFRICA AT 'BB+'; OUTLOOK STABLE

Fitch Ratings-Hong Kong-01 June 2017: Fitch Ratings has affirmed South Africa's Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) at 'BB+' with a Stable Outlook. The issue ratings on South Africa's senior unsecured foreign- and local-currency bonds and on the sukuk trust certificates issued by RSA Sukuk No. 1 Trust have also been affirmed at 'BB+'. The Short-Term Foreign- and Local-Currency IDRs and the rating on the short-term local-currency securities have been affirmed at 'B'. The Country Ceiling has been affirmed at 'BBB-'.

KEY RATING DRIVERS
South Africa's ratings are weighed down by low trend GDP growth, sizeable contingent liabilities and deteriorating governance. Positively, they are supported by deep local capital markets, a favourable government debt structure and a track record of fairly prudent fiscal and monetary policy.

A cabinet reshuffle at the end of March, which triggered an earlier downgrade of South Africa's ratings, is likely to undermine governance of state-owned enterprises (SOEs), weaken fiscal consolidation and reduce private sector investment as a result of weaker business confidence. While efforts to improve the SOE governance framework will continue, implementation decisions, for example on appointments of senior SOE management, will hamper these efforts and could lead to weaker financial positions of SOEs and higher contingent liabilities for the government.

As the new Finance Minister has emphasised, the government's commitment to existing fiscal targets still stands. As a result, it is unlikely that the government will raise its expenditure ceilings which have served as a key anchor for fiscal policy. The government is also likely to implement some tightening if, as is expected, revenue underperforms but the adjustment will be insufficient to keep deficit targets on track.

Senior ANC and government leaders have emphasised that the government's recent rhetoric of "radical socioeconomic transformation" signals no fundamental change and that the government remains focused on the long-standing goal of inclusive growth. Documents released ahead of the ANC policy conference in June also indicate policy continuity, including on the sensitive issue of land expropriation. Severe tensions within the ANC also limit the ability to make radical policy changes but they also undermine policy predictability as it is unclear which factions will prevail on individual policy issues.

In-fighting within the ANC will remain particularly strong ahead of the electoral conference in December 2017, when the ANC will select a new party president. The new party leader will likely become the country's president after national elections in 2019 or earlier. Even after the electoral conference, policy will still be influenced by competing factions in the ANC and the government will juggle multiple complex policy objectives, in particular improving business confidence and addressing the high degree of inequality.

South African GDP growth remains a key rating weakness, with a five-year average of just 1.6% compared with a 'BB' category median of 3.5%. Growth fell to just 0.3% in 2016 and is expected to rise only moderately to just 1% in 2017 and 1.8% in 2018, as political uncertainty will continue to weigh on private investment. The recovery reflects lower inflation combined with stable wage growth, which will boost real consumer income. In addition, a record harvest in 2017 will boost growth after a severe drought had weighed on GDP growth in 2016.

The government's February budget projected the consolidated national government deficit to narrow to 3.1% of GDP in FY17/18 (year end March) and 2.8% in FY18/19 from 3.4% in FY16/17. However, this relied on optimistic GDP growth forecasts of 1.3% for 2017 and 2% for 2018 and benign assumptions for tax multipliers. Particularly the gains from tax measures of 0.6% of GDP are uncertain. We expect the government to announce some expenditure cuts in its medium-term budget policy statement in October, but this will not fully offset the tax shortfall. As a result, we foresee a consolidated national government deficit of 3.3% in FY17/18 and 3.1% FY18/19.

South Africa's general government debt, at 52.6% of GDP (including local government debt) in March 2017, is above the 'BB' and 'BBB' category medians of 51% and 41%, respectively. We expect debt to continue rising over the next two years, to 55.1% of GDP in FYE19. However, the low share of foreign currency debt in total debt, at 11.5% compared with a 'BB' median of 51%, and the long average maturity of its bonds of 14.7 years reduce the risk of financing difficulties.

The government has guarantees for SOEs, independent power producer contracts and public-private partnerships of ZAR445 billion (10.1% of GDP). In addition, at FYE16 SOEs' debt without an explicit government guarantee totalled ZAR463 billion (10.5% of GDP). Given the weak state of SOE finances, the problems in SOE governance and the importance of SOEs for the country's economy and politics, the risk that some of this debt will land on the sovereign balance sheet is substantial.

The risks are illustrated by the problems of South African Airways, which the Ministry of Finance deems technically insolvent, although its liabilities are small. Eskom, as the biggest recipient of government guarantees, received significant capital injections from the government in 2015 but is not expected to require further support in the near term. South Africa's plan to build 9.6GW of nuclear electricity capacity, to be implemented by Eskom, could raise government exposures significantly. However, a court decision in April has significantly delayed progress towards signing procurement contracts, as the government will need to relaunch consultations.

South Africa's current-account deficit has narrowed to 3.2% of GDP in 2016 from a peak of 5.9% in 2013 and is likely to remain around 3% in 2017 and 2018. Weak growth of domestic demand, particularly import-intensive private investment, has led to import compression. A weak rand has also improved the competitiveness of domestic goods and services. Recent strengthening of prices for some of South Africa's key export commodities will also support export receipts and the strong harvest will reduce the need for food imports. Reserves are low relative to financing requirements and the high commodity share in exports adds to volatility in export receipts, but the fully flexible exchange rate will act as a buffer for external financing shocks.

Most indicators of economic development are in line with 'BB' category medians. GDP per capita at market prices is estimated at USD5,246 for 2016, compared with a median of USD5,058. The World Bank's governance indicator, at the 59th percentile, is well above the 'BB' median but this may not adequately reflect governance issues that were highlighted in the recent state of capture report by the public prosecutor and governance may deteriorate as a result of the government reshuffle. The rating is supported by a sound banking sector, which has a Fitch Bank Systemic Risk Indicator of 'bbb'.

SOVEREIGN RATING MODEL (SRM) and QUALITATIVE OVERLAY (QO)
Fitch's proprietary SRM assigns South Africa a score equivalent to a rating of 'BBB' on the Long-Term Foreign-Currency IDR scale.

Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final Long-Term Foreign-Currency IDR by applying its QO, relative to rated peers, as follows:

Macroeconomic Performance, Policies and Prospect: -1 notch, to reflect South Africa's weak growth prospects relative to the 'BB' and 'BBB' category medians, with important repercussions for public finances.

Structural Features: -1 notch, to reflect the expected deterioration in governance standards, particularly related to SOEs.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three year-centred averages, including one year of forecasts, to produce a score equivalent to a Long-Term Foreign-Currency IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

RATING SENSITIVITIES
The following risk factors could, individually or collectively, result in negative rating action:

- A marked increase in the government debt/GDP ratio or in contingent liabilities;

- A further deterioration in South Africa's trend GDP growth, for example, due to sustained uncertainty about economic policy;

- Rising net external debt to levels that raise the potential for serious financing strains.

The following risk factors could, individually or collectively, result in positive rating action:

- A substantial strengthening in trend GDP growth;

- An improvement in governance that is supportive of public finances and the business climate;

- A marked narrowing in the budget deficit and a reduction in the government debt/GDP ratio.

KEY ASSUMPTIONS
Fitch expects global economic trends and commodity prices to develop as outlined in Fitch's Global Economic Outlook.

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Applicable Criteria
Country Ceilings (pub. 16 Aug 2016)
https://www.fitchratings.com/site/re/885997
Criteria for Rating Sukuk (pub. 16 Aug 2016)
https://www.fitchratings.com/site/re/885806
Sovereign Rating Criteria (pub. 18 Jul 2016)
https://www.fitchratings.com/site/re/885219

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