FitchRatings

Fitch Affirms South Africa at 'BB+'; Outlook Stable

Fitch Ratings-Hong Kong-23 November 2017: Fitch Ratings has affirmed South Africa's Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'BB+' with a Stable Outlook.

A full list of rating actions is at the end of this rating action commentary.

KEY RATING DRIVERS
South Africa's ratings are weighed down by low trend growth, sizeable government debt and contingent liabilities and deteriorating governance standards. These weaknesses are balanced by a favourable government debt structure, deep local capital markets and a flexible exchange rate that helps to absorb external shocks. The affirmation reflects that while a number of developments point to a weaker fiscal outlook and consequent faster pace of debt accumulation, potential fiscal consolidation measures after the ANC's elective conference in December could mitigate those trends. Additionally, GDP growth could recover more strongly than currently anticipated if the outcome of the conference is viewed favourably by consumers and businesses.

In its Medium-Term Budget Policy Statement (MTBPS), the government lowered its forecast for revenues by ZAR51 billion (1.1% of GDP in FY17/18), with similar reductions in subsequent years. As a result, forecasts for deficits and government debt for the full three-year forecast period were raised substantially. The general government budget deficit for FY17/18 is now forecast to be 4.3% of GDP, much higher than the forecast in the February budget of 3.1% but in line with our revised forecast.

The government now forecasts gross loan debt (excluding local authorities) to stand at 60.8% of GDP in FY21/22 and to remain on an upward trend, compared with a forecast in the February budget for debt to start declining from FY18/19 to 51.9% by FY21/22. We now forecast a fiscal deficit of 3.6% of GDP in FY18/19 and FY19/20 and expect general government debt (gross loan debt plus local government debt of around 2% of GDP) to rise to 59.2% of GDP in FY19/20 from 52.6% in FY16/17. This represents a material increase from the previous assumption of 55.1% for FY18/19 at our last rating review in June 2017.

Shortly after the MTBPS it emerged that the government plans to raise spending on tertiary education. Details are still to be worked out, but we assume the initiative will cost about 0.5% of GDP per year, with a lower impact in the initial year. The possibility of a costly National Health Insurance scheme also remains, although a recent report to the National Treasury concluded this is unaffordable under current economic conditions. We also assume on-going public sector wage negotiations will result in slightly higher wage rises than anticipated in the MTBPS.

In the MTBPS, the government forecasts that it will breach the expenditure ceiling in FY17/18, although this may still be avoided in the final out-turn. The importance of the National Treasury in the budget process may also have declined with the establishment of the Presidential Fiscal Committee. The government also did not propose significant consolidation measures in response to the heightened fiscal pressures. In Fitch's view, to some extent this reflects policy paralysis ahead of the ANC's elective conference in December. We assume that the budget to be presented in February 2018 will contain revenue- and expenditure-side consolidation measures that are already being discussed by the Presidential Fiscal Committee but that were not yet factored into the MTBPS. Nevertheless, the combination of these developments suggest a decline in commitment to fiscal consolidation, which if not addressed, would place downward pressure on the ratings.

Total contingent liabilities including SOE debt (with and without state guarantees) and guarantees for independent power producers and public private partnerships amounted to 21% of GDP in 2017. Financial pressures and governance challenges have raised the risk that SOE-related contingent liabilities could migrate to the sovereign balance sheet, although in Fitch's view its capacity to provide financial support to distressed SOEs may be declining. Due to concerns over governance, many creditors of SOEs have stopped rolling over existing facilities leading to liquidity pressures, notably at Eskom, the main electricity supply and distribution company. The plan for large investments in nuclear power generation is still progressing, despite some legal setbacks. This could lead to a large further increase in government guarantees over the long term.

Political uncertainty is elevated ahead of the ANC's five-yearly elective conference on 16 to 20 December, which will choose the successor to Jacob Zuma as chairman of the party and the likely successor to Mr Zuma as president of South Africa after the 2019 parliamentary election (or earlier if Mr Zuma does not complete his full term). The run-up to the party conference has contributed to policy paralysis, and we assume that the situation will not immediately improve after the conference. Issues to be resolved include the reality that both of the main candidates will need to form complex alliances to win, that a split of the party chairmanship and the national presidency could lead to inefficiencies and that disruptive in-fighting between factions is likely to continue.

South Africa experienced a recession in 4Q16 and 1Q17 but recovered in 2Q17. Fitch forecasts growth of 0.7% in 2017 with only a moderate recovery to 1.6% in 2018 and 2% in 2019. A significant impediment to growth is low business confidence reflecting considerable concerns about the political environment, as reflected in BER manufacturing business surveys. A resolution of these concerns could lead to a stronger recovery but this is currently not our baseline scenario. In Fitch's view, growth will continue to be held back by structural weaknesses such as skills mismatches and inefficiencies in the wage-setting process. As a result, growth is likely to remain insufficient to significantly reduce large inequalities, leading to pressures for redistributive policies that further weaken the growth potential.

Low private sector investment and private consumption have depressed imports, leading to a significant narrowing in the current account deficit, to around 2% in 2017. The expected moderate recovery in growth will lead to a slow widening of the deficit. Net external debt, at 12.1% of GDP in 2017, is in line with 'BB' category peers. Foreign ownership of government debt securities is high, exposing the country to sudden shifts in investor sentiment, but the flexible exchange rate and low level of public external debt reduce vulnerabilities.

The World Bank's governance indicator for South Africa is well above the 'BB' category median, but wide-spread reporting of governance failures at SOEs suggests that the indicator exaggerates the country's strength in this area. Other structural indicators, such as GDP per capita, are broadly in line with peers. Banks are generally well regulated and profitable making it unlikely that the sovereign will need to support the sector.

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 (LT FC) IDR scale.

Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final LT FC IDR by applying its QO, relative to rated peers, as follows:

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

Structural Features: -1 notch, to reflect that the deterioration in governance standards, particularly related to SOEs, in Fitch's view is not fully reflected in the World Bank governance indicator, which remains supportive.

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 LT FC 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 failure to implement credible fiscal consolidation to arrest the upward trajectory of the government debt/GDP ratio, or a heightened risk that SOE debt will migrate to the sovereign's balance sheet.
- A further deterioration in South Africa's trend GDP growth rate, for example, due to sustained uncertainty about economic policy or governance concerns.
- 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 standards, including for SOEs, that is supportive of public finances and investment.
- 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.

The full list of rating actions is as follows:

Long-Term Foreign-Currency IDR affirmed at 'BB+'; Outlook Stable
Long-Term Local-Currency IDR affirmed at 'BB+'; Outlook Stable
Short-Term Foreign-Currency IDR affirmed at 'B'
Short-Term Local-Currency IDR affirmed at 'B'
Country Ceiling affirmed at 'BBB-'
Issue ratings on long-term senior unsecured foreign-currency bonds affirmed at 'BB+'
Issue ratings on long-term senior unsecured local-currency bonds affirmed at 'BB+'
Issue ratings on short-term senior unsecured local-currency bonds affirmed at 'B'
Issue ratings on sukuk trust certificates issued by RSA Sukuk No. Trust affirmed at 'BB+'

Contact:
Primary Analyst

Jan Friederich
Senior Director
+852 2263 9910
Fitch (Hong Kong) Limited
19/F Man Yee Building
68 Des Voeux Road Central
Hong Kong

Secondary Analyst
Jermaine Leonard
Director
+852 2263 9830

Committee Chairperson
Tony Stringer
Managing Director
+44 20 3530 1219

Media Relations: Peter Fitzpatrick, London, Tel: +44 20 3530 1103, Email: peter.fitzpatrick@fitchratings.com; Wai-Lun Wan, Hong Kong, Tel: +852 2263 9935, Email: wailun.wan@fitchratings.com.

Additional information is available on www.fitchratings.com

Applicable Criteria
Country Ceilings Criteria (pub. 21 Jul 2017) (https://www.fitchratings.com/site/re/901393)
Sovereign Rating Criteria (pub. 21 Jul 2017) (https://www.fitchratings.com/site/re/901261)
Sukuk Rating Criteria (pub. 14 Aug 2017) (https://www.fitchratings.com/site/re/902221)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form (https://www.fitchratings.com/site/dodd-frank-disclosure/1032818)
Solicitation Status (https://www.fitchratings.com/site/pr/1032818#solicitation)
Endorsement Policy (https://www.fitchratings.com/regulatory)

Solicitation Status

Fitch Ratings was paid to determine each credit rating announced in this Rating Action Commentary (RAC) by the obligatory being rated or the issuer, underwriter, depositor, or sponsor of the security or money market instrument being rated, except for the following:

Endorsement Policy - Fitch's approach to ratings endorsement so that ratings produced outside the EU may be used by regulated entities within the EU for regulatory purposes, pursuant to the terms of the EU Regulation with respect to credit rating agencies, can be found on the EU Regulatory Disclosures (https://www.fitchratings.com/regulatory) page. The endorsement status of all International ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for all structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.