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South Africa, Government of:

Key Drivers for Downgrade of Rating to Baa2; Outlook Stable

RATINGS

South Africa, Government of

FC Gov. Bond Rating/Outlook	Baa2/Stable
LC Gov. Bond Rating/Outlook	Baa2/Stable
LC Bond/ Deposit Ceiling	A1
FC Bond Ceiling	A2
FC Deposit Ceiling	Baa2

KEY INDICATORS

	2013	2014F	2015F
Real GDP (%)	1.9	1.4	2.5
CPI (Dec/Dec %)	5.3	6.0	5.5
Financial Balance (% GDP)	-4.0	-4.0	-3.5
Current Account Balance (% GDP)	-5.8	-5.6	-5.4

Source: Haver Analytics, Official National Sources Moody's Investors Service

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» On 6 November 2014, we downgraded the South African government's ratings to Baa2 from Baa1 and affirmed its short-term rating at P(P-2). The key drivers of the rating downgrade are the following:

1. Poor medium-term growth prospects due to structural weaknesses, including ongoing energy shortages, as well as rising interest rates, further deterioration in the investor climate and a less supportive capital market environment for countries such as South Africa that are highly dependent on external capital.

2. The prospect of a further rise in the government debt-to-GDP ratio implied by the low growth environment, which even strict compliance with the government's spending ceiling and somewhat smaller fiscal deficits are unlikely to arrest in the near term.

» South Africa's Baa2 investment grade rating is supported by its position as the most developed country in Africa, offering one of the deepest capital markets and most sophisticated financial systems among emerging markets. The economy has a diversified productive base, with substantial value-added from domestic sources and an advanced infrastructure, while its institutions, most notably its judiciary, are stronger than many of its peers.

» The assignment of a stable outlook reflects policymakers' commitment to reining in government debt growth over the medium term and the broad political support for a macroeconomic strategy, including the National Development Plan (NDP), tighter monetary policy and fiscal restraint, which should help stabilize the debt burden over the medium term.

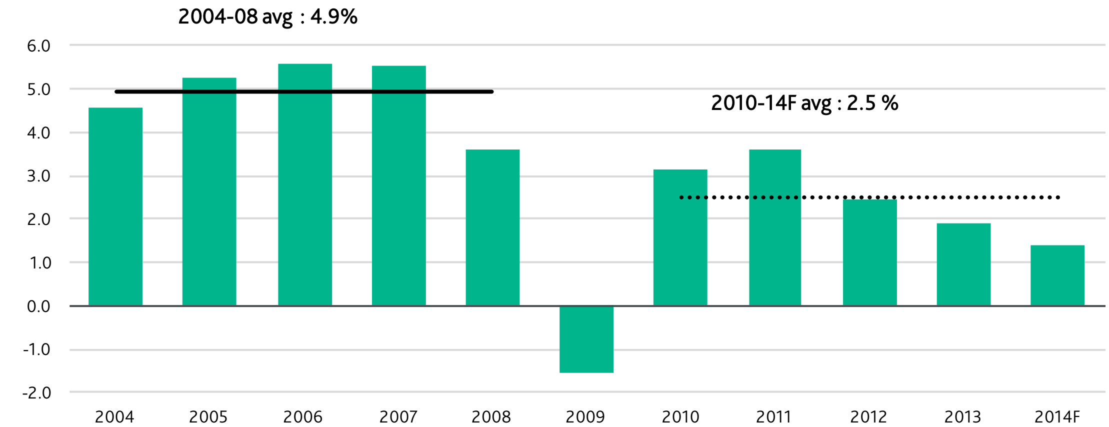
» This report provides further insight into the drivers of our decision to downgrade South Africa's rating and why we assigned a stable outlook to the Baa2 rating.

Rationale for the downgrade to Baa2

First downgrade driver: Low economic growth tied to structural constraints

The first driver for the downgrade of South Africa's long-term debt rating to Baa2 is the weak outlook for real growth over the coming years, continuing the below-potential performance of 2012-14 (see Exhibit 1). The South African economy has been damaged this past year by a confluence of domestic and external factors, which suggests that growth will continue to come in below potential for the foreseeable future. A protracted strike in the platinum industry and a much shorter, but deeply damaging strike in the metalworkers sector in July combined to slow growth this year, increase negative perceptions of the local investment climate, and prevent exporters from taking advantage of a more competitive exchange rate and (maybe temporarily) stronger demand from Europe.

EXHIBIT 1
South Africa's growth is noticeably lower post-2009
Real GDP Growth (% change)



Source: Haver Analytics, South Africa Reserve Bank, Moody's Investors Service

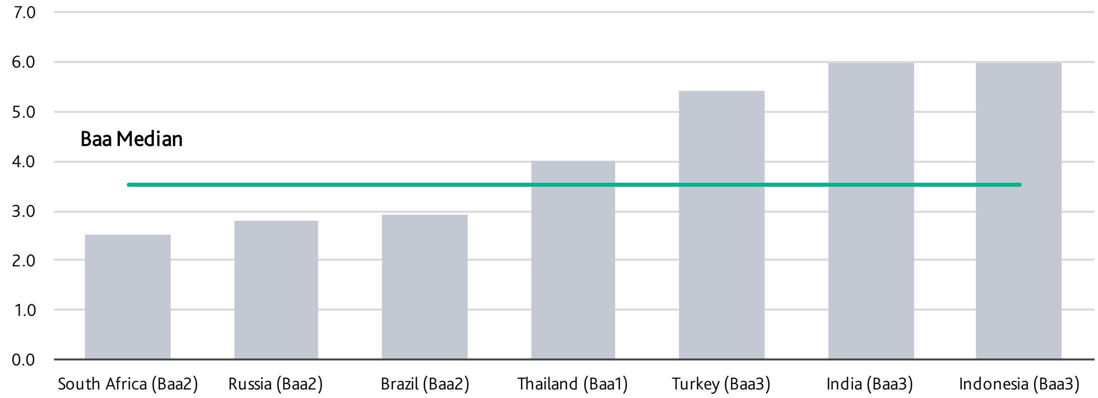
We have revised down our forecasts for real GDP growth to 1.4% in 2014, followed by a 2.5% increase in 2015,[1] and expect that the economy will not reach its long-run potential growth rate of roughly 3% until 2018 because of ongoing energy shortages and other structural constraints. These low projections are also subject to material downside risks from both domestic sources – mainly new strike activity – and external sources, particularly a slowdown in demand from China, South Africa's single largest export market, and weak growth in world trade generally. Even if such impediments are overcome, real growth is likely to come in below levels seen a few years ago and remain below peers (see Exhibit 2).

[1] That said, arithmetic effects would pose potential upside risks to the growth rate of around 0.5% in 2015 if, as expected, the fourth quarter ends on a high note due to a rebound from the strike-depressed first three quarters.

EXHIBIT 2

South Africa's growth lags peers

Average Real GDP Growth 2010-2014F (% change)



Source: Haver Analytics, South Africa Reserve Bank, Moody's Investors Service

Energy constraints will hold back growth for several more years

Energy shortages, which have been a growth constraint off and on since early 2008, have become especially binding in 2014 and will remain problematic until mid-2017 when substantial new electricity generation capacity comes fully on stream. Between December 2014 and then, activation of the individual units of two new coal-fired plants will simply be offsetting planned and unplanned downtime at existing plants that have been operating at full capacity and in some cases, well beyond their expected lives. Usage will therefore continue to be restricted during this period.

South Africa's exports are highly energy-intensive, so shortfalls in electricity availability explain why we expect exports will expand slowly for several more years even though the exchange rate is now more competitive. As a result, the current account deficit is expected to remain at relatively wide levels of around 5.5% of GDP through 2017. Moreover, net external financing has also turned into a small outflow so far this year because of the negative impact on emerging market currencies from the US Federal Reserve's gradual winding down of its quantitative easing program. This trend could continue over the next two to three years, putting additional downward pressure on the exchange rate and new strains on the central bank's foreign exchange reserves.

The government's long-term National Development Plan (NDP) is designed to address the country's structural weaknesses over time, but in the meantime they will continue to hold back growth. Essential elements of the NDP – such as labor market reform aimed at normalizing industrial relations and reforms to improve education standards geared towards raising the country's very low participation rate – would be important drivers of potential growth in the coming years, although their efficacy is as yet unproven. That said, highly encouraging preliminary results have been seen with the introduction of the Employment Tax Incentive Act, which is one of the NDP elements already adopted.

Labor market instability likely to get worse before it gets better

South Africa's labor market instability is a major factor behind the poor investment climate. Labor relations have been particularly fractious this year: the longest strike in the country's history, staged by platinum workers, was followed by the country's largest one (in terms of the numbers of strikers) when the National Union of Metalworkers (Numsa) and several affiliated unions went on strike for a month in July.[2]

[2] See Moody's Issuer Comment "South African Metalworkers' New Strike Will Cause More Pain for the Economy" July 3, 2014.

The turmoil has worsened – and violence heightened – due to the advent of competition between unions aligned politically with the ANC, in particular Cosatu (Confederation of South African Trade Unions), the ANC's partner in the government's Tripartite Alliance, and Amcu (Association of Mineworkers and Construction Unions), a new apolitical union that aggressively recruits members away from traditional unions by promising better wages and benefit increases. This dynamic has injected an element of increased inflexibility to wage negotiations in South Africa.

We also note that the advent of Amcu exacerbated existing splits taking place within and among Cosatu over opposition to the ANC's economic policies, which led its largest member union, Numsa, to refrain from campaigning for the ANC during the 2014 election campaign and ultimately, Numsa's expulsion from Cosatu on November 8. This break represents a major disintegration of the labor groups that for decades backed the ANC in the struggle against apartheid. Ultimately, we expect that such a break will be healthy for South Africa's democracy but in the near to medium term, it is likely to heighten labor market intransigence and instability.

Deterioration of business climate deters private investment

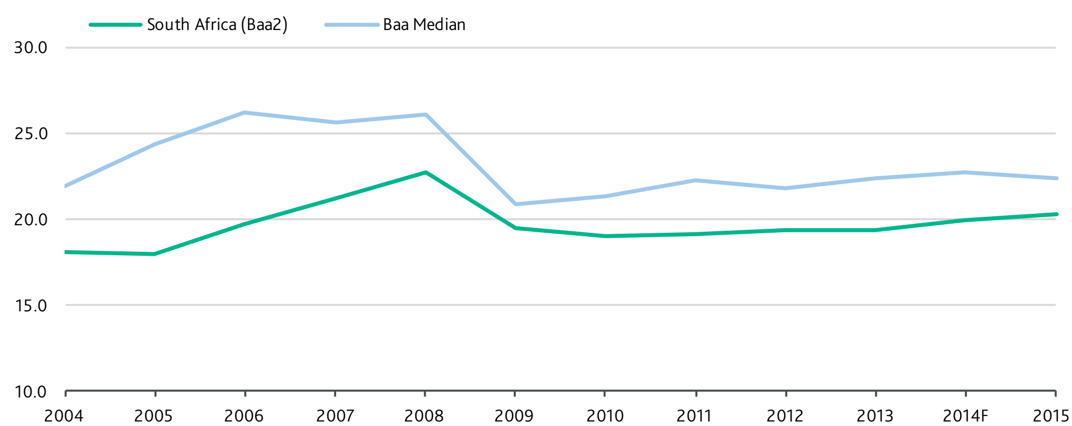
The downturn in business confidence has been deterring a recovery of fixed investment while also taking a toll on local fixed income markets. This has hindered efforts to raise investment rates above the current 20% of GDP and take growth to the 5%-6% level that would reduce the unemployment rate from the roughly 25% where it has been stuck for most of the last 20 years.

Although the government investment program, including the expansion of infrastructure undertaken by state-owned enterprises like Transnet and Eskom, has stepped up significantly in recent years, private sector investment has been lagging since the global financial crisis (see Exhibit 3), taking growth below that of peers. The only era when progress was made in bringing down unemployment rates was in the mid-2000s when growth averaged 5% for three consecutive years, a pace that is now out of reach for the reasons already identified. We expect that the recent weakness in commodity prices will reinforce businesses' reluctance to invest in the mining sector over the next year at least.

EXHIBIT 3

Despite an increase in public investment, South Africa continues to underperform peers

(Investment/GDP (%))

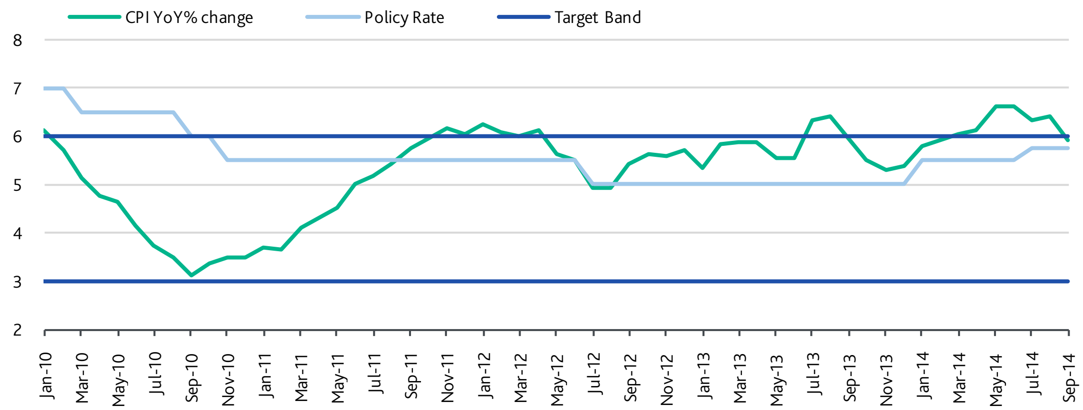


Source: :Haver Analytics, South Africa Reserve Bank, Moody's Investors Service

High unemployment is also preventing a more substantial increase in real incomes and the rise in savings rate to levels needed to support higher levels of growth without exacerbating external imbalances. South Africa's weakened investment climate is particularly relevant in view of the less supportive capital market environment for South Africa and other countries that depend on capital inflows to finance large current account deficits.

Growth will also be vulnerable to the expected rise in policy rates, which have been at record low nominal rates and negative in real terms for several years. The Reserve Bank (SARB) plans to gradually bring real rates back into positive territory, although it is unclear at exactly what level. After a surprise hike of 50 bps in response to the steep fall in the rand exchange rate in January and another 25 bps in July, rates have been on hold in recent months as the pass-through from the depreciation of the rand since last May has been weaker than expected. Inflation peaked earlier than expected at 6.6% in May-June and similarly returned to within the 3%-6% inflation target range faster than expected in September (see Exhibit 4).

EXHIBIT 4
Rising interest rates present a risk to growth



Source: Haver Analytics, South Africa Reserve Bank, Moody's Investors Service

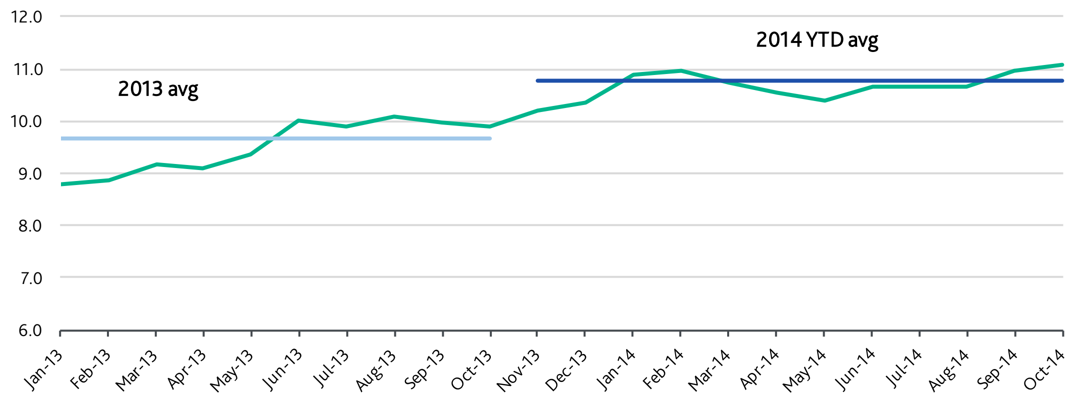
Statements of SARB's Monetary Policy Committee have mentioned the weak economic environment as one factor that is likely holding down the pass-through of the rand's depreciation this year relative to earlier episodes of currency weakness. When interest rates do rise, however, it will negatively affect lower-income households in particular, who are heavily indebted. The overall ratio of household debt to disposable income has declined by roughly 10 percentage points from its 2008 peak of 82%, but lenders say that the improvement is mainly among higher-income groups.

Other factors hindering growth are the weaker exchange rate (see Exhibit 5), which will restrain purchases of consumer and investment goods with a high import content. Double-digit increases in the prices of such necessities as transport and electricity will at least partly offset any benefit from lower oil prices. As mentioned above, exports are unlikely to see a significant pick up from the more competitive exchange rate given that they are highly energy-intensive and are constrained by ongoing energy shortfalls.

EXHIBIT 5

Weakening exchange rate will further dampen domestic demand

(Rand/$US Exchange Rate)



Source: Haver Analytics, South Africa Reserve Bank, Moody's Investors Service

Second downgrade driver: Rising debt metrics despite spending restraint

The second driver of the downgrade to Baa2 is the continued deterioration in the government's debt metrics in spite of its strict adherence to expenditure ceilings (see Exhibits 6 & 7). Just after our downgrade of the government's ratings from A3 to Baa1 in September 2012, the government stepped up its fiscal consolidation efforts and advised that it would limit spending to keep within its medium-term framework rather than allowing spending to drift upwards in the second and third years as had been the case in the past. As a result, the government spending to GDP ratio has been on a mildly downward path since FY 2013/14. In spite of these adjustments, however, fiscal deficits remain large at 4% of GDP.

Large fiscal deficits and weak growth will lead to a rise in debt levels over the next two years

EXHIBIT 6

Financial Balance/GDP (%)

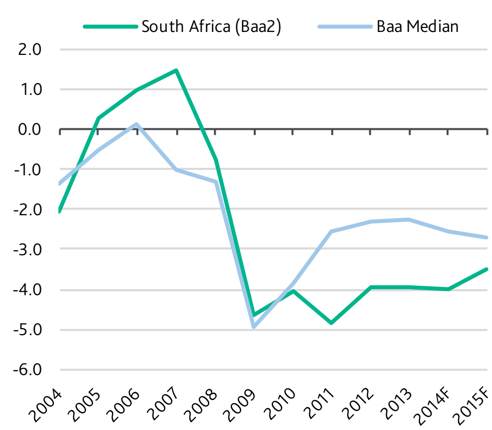
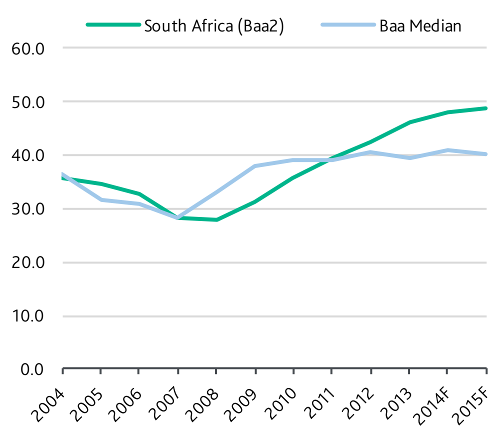


EXHIBIT 7

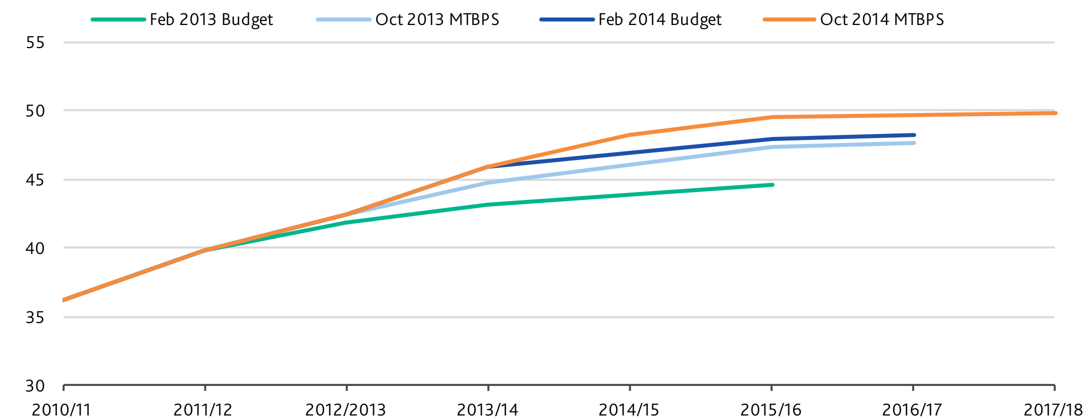
Debt/GDP (%)



Source: Haver Analytics, National Treasury, Moody's Investors Service

The combination of recurring fiscal deficits and subdued nominal GDP growth has caused the government to make successive upward revisions to its debt to GDP projections (see Exhibit 8). In the latest Medium-Term Budget Policy Statement (MTBPS), the government expects its gross debt ratio to rise over the next two years, reaching a peak of nearly 50% of GDP at the consolidated national level, up from 39% in 2011/12. Interest payments are the fastest-growing item in the budget, so the interest to revenue ratio will also rise further to 9% next year after having reached a low of 7.1% in 2008.

EXHIBIT 8
Successive upward revisions in debt ratios due to low growth in nominal GDP
(Debt/GDP (%))



Rationale for changing the rating outlook to stable

We note that South Africa's Baa2 investment grade rating reflects its position as the most developed country in Africa, offering one of the deepest capital markets and most sophisticated financial systems among emerging markets. The economy has a diversified productive base, with substantial value-added from domestic sources. The country's infrastructure is highly advanced compared with most other emerging markets and its institutions, most notably its judiciary, are stronger than many of its peers. Twenty years after the democratic transition, important achievements include the early establishment of macroeconomic policy credibility; an expansion of services, housing and utilities; and the emergence of a growing black middle class.

Our decision to change South Africa's rating outlook to stable from negative reflects the credibility of policymakers' commitment to contain increases in government deficits and debt. The Baa2 rating appropriately captures the weak growth environment as well as the erosion of the South African government's balance sheet. After successive upward revisions in government debt to GDP projections driven by weak nominal GDP growth, a stabilization of the deficit and debt ratios is in sight now that deficit targets and spending ceilings have been cut for the next three years.

We expect government efforts to restrict current spending – including the wage bill – in order to protect its infrastructure expansion efforts as an important part of its broader efforts to enhance longer-term growth prospects by eliminating infrastructure bottlenecks without significantly loosening fiscal policy. Moreover, policymakers are no longer counting on a recovery of growth to bring down deficits in the future. Aside from cuts in the existing spending ceilings for 2015/16 and 2016/17, the MTBPS outlines newly-lowered fiscal deficits limits rather than targets, having built in buffers to the projections that should allow the deficits to be achieved except in extraordinary circumstances. We view this distinction as important given the downside risks to growth on both the domestic and external fronts.

MTBPS 2014 – Higher revenue from tax increases vs. lower spending plans in 2014 MTBPS

EXHIBIT 9
Revenue YoY% Growth

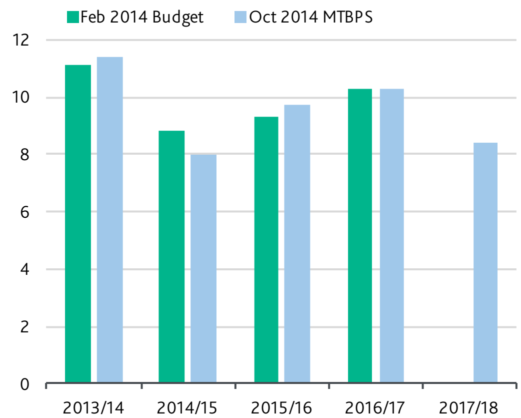
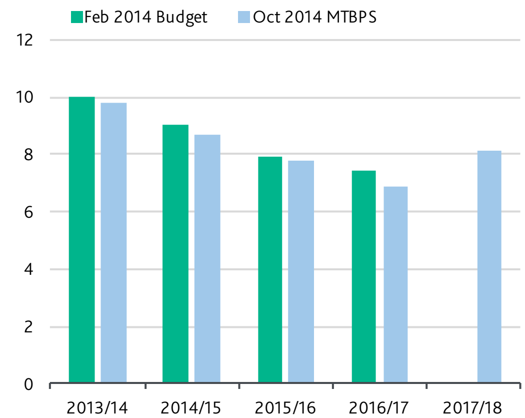


EXHIBIT 10
Expenditure YoY% Growth



Source: National Treasury

Finance Minister Nene also announced during his Medium Term Budget Policy Statement speech that the government will resist additional requests for financial support from state-owned companies and development banks going forward, and will encourage them to undertake reforms and achieve efficiencies that will allow them to remain financially sustainable on their own. To date, government guarantees for these firms comes to the equivalent of around 14% of GDP, although not all of the guarantees have been exercised. The government's latest (and supposedly final) extension of financial support to state-owned electricity monopoly Eskom will be fiscally neutral, since the current plan involves selling existing state assets to raise the cash the government will provide to the cash-strapped firm.

Resolute support from the highest levels of government for the NDP provides another reason for stabilizing the rating outlook. One example of this support was that even before the election, and against longstanding opposition from the trade unions that are part of the ANC-led Tripartite Alliance, the ANC leadership pushed forward on employment subsidies for entry-level workers – one of the recommendations in the NDP. The program has become more successful than anticipated and will shore up efforts to bring more young people into the workforce and increase their skills.

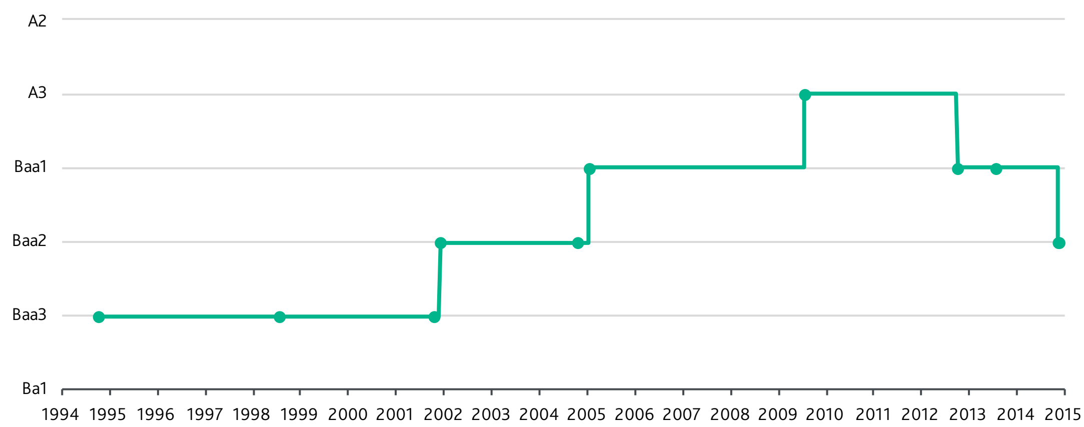
What could change the rating up/down

The successful implementation of planned structural reforms to enhance potential growth and reduce exposure to external shocks, combined with continued fiscal prudence, would support sovereign creditworthiness and exert upward pressure on the rating. Reforms resulting in higher domestic savings and investment rates and stronger, sustainable growth, alongside continued restraint in public debt accumulation and the ongoing implementation of the macro and micro-level reforms embedded in the NDP, could also provide positive momentum to the rating.

South Africa's ratings could be downgraded if the official commitment to fiscal consolidation and debt stabilization falters, or if the investment climate deteriorates further, imperiling the availability of external financing for the current account deficit.

Ratings History

South Africa, government of



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