

December 7, 2007

South Africa (Republic of)

Primary Credit Analyst:

Farouk Soussa, PhD., London (44) 20-7176-7104; farouk_soussa@standardandpoors.com

Secondary Credit Analyst:

Remy Salters, London (44) 20-7176-7113; remy_salters@standardandpoors.com

Table Of Contents

Major Rating Factors

Rationale

Outlook

Comparative Analysis

Political Environment: All Eyes On Leadership Transition

Economic Prospects: Sustained Effort To Boost Potential Growth

Fiscal Flexibility: Debt Keeps Falling On Prudent Stance

Monetary Policy: Central Bank Tightens The Reins

External Finances: Higher Imbalance Is Here To Stay

South Africa (Republic of)

Major Rating Factors

Strengths:

- Prudent macroeconomic policies and a moderate debt burden
- An independent central bank committed to low inflation, well-developed capital markets, and a strong financial sector
- Political stability and transparent institutions

Weaknesses:

- Structural economic weaknesses and deep social inequalities
- Vulnerability to volatile capital inflows

Sovereign Credit Rating
Foreign Currency
BBB+/Stable/A-2
Local Currency
A+/Stable/A-1
South African National Scale
zaAAA/--/zaA-1

Rationale

The ratings on the Republic of South Africa are supported by its prudent macroeconomic policies, a moderate debt burden, and strong and stable political institutions. These are balanced by vulnerable external finances because of a continued high reliance on portfolio inflows, and severe structural socioeconomic weaknesses, including income disparities, poverty, high unemployment, and the impact of HIV/AIDS.

Rising inflationary pressures in the context of strong domestic demand, rapid credit growth, and large exchange rate movements due to periodical turbulence in emerging markets have increasingly challenged South Africa's economic policies in recent years. In response, the South African Reserve Bank (SARB) has pursued tighter monetary policies throughout 2006 and 2007. The National Treasury is also targeting a surplus budget for 2007/2008 (fiscal year ending March 31, 2008), mindful of the emerging imbalances in the South African economy and the need to increase the national savings rate.

Consistently prudent macroeconomic policies have created the favorable conditions necessary to lift and sustain higher growth rates in the medium term. Standard & Poor's Ratings Services forecasts GDP growth at about 5.0% annually out to 2010, compared with 3.7% in 2001-2005, although the resurgence of inflationary pressures has heightened downside risks.

The central government budget for 2006/2007 closed with a small surplus of 0.6% of GDP. A similar performance is expected in 2007/2008, and small surpluses are also projected in the medium term, underpinned by a moderation in spending growth and still-dynamic revenues. As a result, general government debt will edge down toward 20% of GDP in the period to 2010, compared with 33% of GDP in 2006.

South Africa's external vulnerabilities have diminished with the buildup of foreign exchange reserves and the decline in external indebtedness. The country is forecast to maintain a small net external creditor position in 2007/2008, with net external assets estimated at about 2.5% of current account receipts (CARs) in 2008. Nevertheless, external liquidity remains a potential weakness. The current account deficit widened to more than 6% of GDP in 2006 and is set to remain at 6%-8% in the period to 2010, with continued strong consumer demand and the government's

capital expenditure program underpinning imports. Net foreign direct investment (FDI) coverage has been an erratic source of financing in recent years, leaving South Africa vulnerable to reversals in portfolio capital inflows.

Outlook

The stable outlook reflects the balance between South Africa's strong public finances and prudent policies on the one hand, and its mix of short-term macroeconomic risks and long-term socioeconomic pressures on the other. Continued responsiveness to the risks associated with the large current account deficit, combined with an enduring commitment to growth-enhancing microeconomic reforms beyond the 2009 general election, could lead to positive rating momentum. In the context of turbulent global markets, however, a larger external imbalance and/or a loosening of macroeconomic policies could increase vulnerability to capital flow reversals, putting downward pressure on the ratings.

Table 1

Republic of South Africa Selected Indicators									
	2010f	2009f	2008f	2007e	2006	2005	2004	2003	'A' median 2007e
GDP per capita (\$)	8,685	7,579	6,674	5,853	5,350	5,103	4,584	3,552	16,111
Real GDP (% change)	4.9	4.9	4.8	4.8	5.0	5.1	4.8	3.1	5.3
Real GDP per capita (% change)	4.4	4.4	4.3	4.3	4.5	4.6	4.2	2.3	4.1
General government balance (% of GDP)	0.3	0.4	0.6	0.9	0.6	(0.6)	(1.7)	(2.6)	(0.6)
General government debt (% of GDP)	21.6	23.8	26.4	29.6	33.3	36.6	37.1	39.7	34.0
Net general government debt (% of GDP)	15.7	17.3	19.2	21.6	24.4	30.1	31.9	35.0	24.2
General government interest expenditures (% of revenues)	9.1	9.3	9.2	7.7	8.7	10.0	11.0	12.6	5.8
Domestic credit to private sector and NFPEs (% of GDP)	92.2	88.8	85.4	82.1	79.3	71.0	66.2	64.2	97.5
Consumer price index (average; % change)	5.0	5.3	6.1	6.0	4.6	3.9	4.3	6.8	2.8
Gross external financing needs (% of CARs and usable reserves)	122.1	120.5	117.1	114.8	114.3	108.3	115.5	110.4	100.5
Current account balance (% of GDP)	(7.5)	(7.2)	(6.7)	(6.5)	(6.4)	(3.8)	(3.2)	(1.1)	(2.0)
Narrow net external debt (% of CARs)	21.5	19.3	17.7	15.7	10.0	1.7	10.2	20.3	2.9

f--Forecast. e--Estimate. NFPE--Nonfinancial public enterprise. CAR--current account receipt.

Comparative Analysis

- Political institutions compare favorably with peers, although socioeconomic challenges to policy are substantial.
- Current account deficits are high and financed by short-term, albeit predominantly non-debt-creating, inflows.
- Government debt is relatively low and falling. The fiscal stance is responsive to current macroeconomic risks, comparing favorably with all peers.

South Africa's closest peers include other sovereigns with significant social and developmental challenges, such as the Republic of India (BBB-/Stable/A-3; all ratings herein refer to foreign currency ratings) and the Republic of China (A/Positive/A-1). The Kingdom of Thailand, the United Mexican States, the Russian Federation, and the Republic of Hungary (all rated BBB+/Stable/A-2), as well as the Republic of Poland (A-/Stable/A-2), also provide useful comparisons.

Political environment compares well

South Africa's political environment is characterized by mature institutions and the dominance of one party, the African National Congress (ANC). Despite the ANC's leading position, a vocal press and well-functioning judiciary underpin pluralism. ANC structures themselves also provide internal checks and balances.

Despite current uncertainties relating to the post-Mbeki handover (see Political Environment), South Africa's pluralism contrasts favorably with the concentration of power characteristic of China under the Communist Party, and Russia under President Vladimir Putin, as well as political uncertainty in Thailand following the military coup of September 2006.

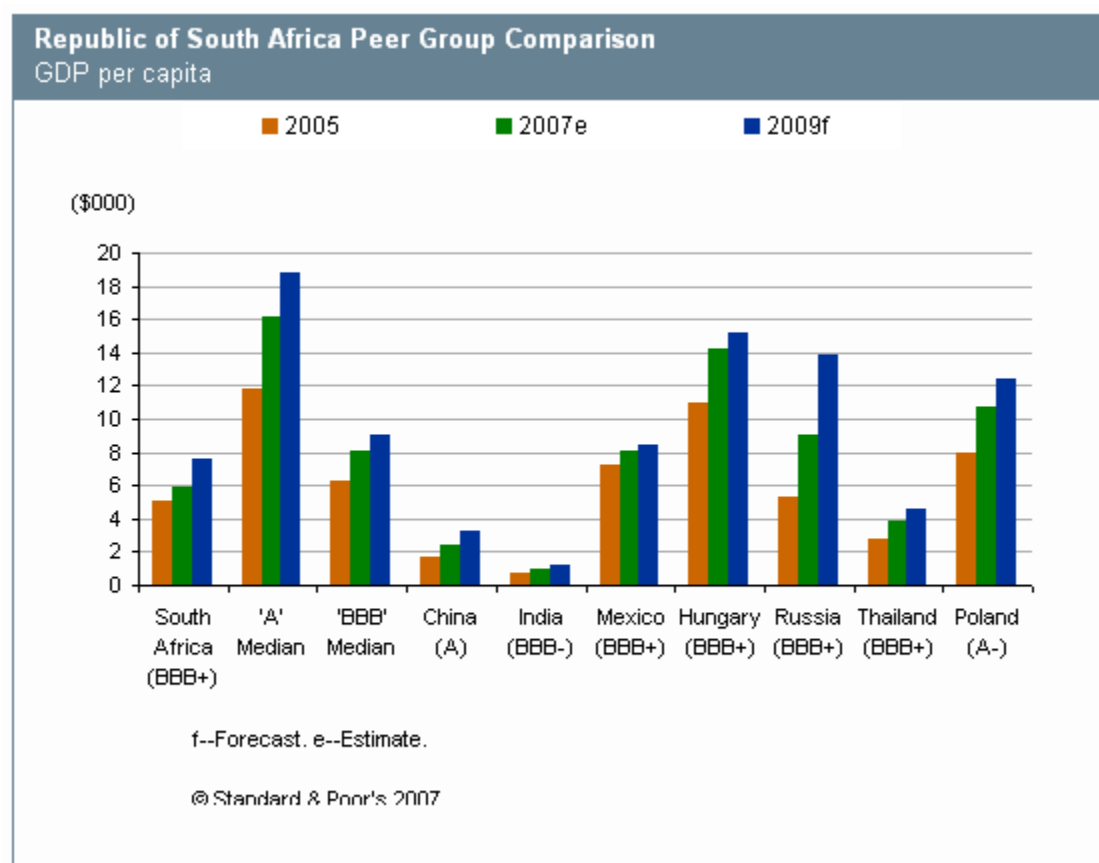
In policy terms, South Africa has been remarkably successful in treading a fine line between macroeconomic prudence and the need for rapid socioeconomic improvements. China presents some parallels, although policies there have encouraged faster but more unbalanced growth. The policy framework in Hungary and Poland is anchored by EU membership and the goal of Eurozone entry. However, the degree to which this sets these two countries apart from South Africa is questionable, as the period since they joined the EU has actually been marked by weaker leverage from the union and reduced predictability.

South Africa's policy profile also compares well with those of India and Mexico. In the latter two countries, there is a more vibrant multiparty parliamentary system, but at the cost of less predictability on the policy front, due to periods of political polarization and/or unwieldy coalitions.

Serious socioeconomic challenges shape policy agenda

Income per capita remains below the 'BBB' median but compares well within the peer group (see chart 1). Health and education challenges, however, are reflected in South Africa's very low ranking of 121 out of 177 countries in the United Nations Development Program (UNDP) Human Development Index. The challenges are comparable in India (126), but much more substantial than for other peers, such as China (81), Thailand (74), and Mexico (53). Poland (37) and Hungary (35) are the best-performing peers.

Chart 1

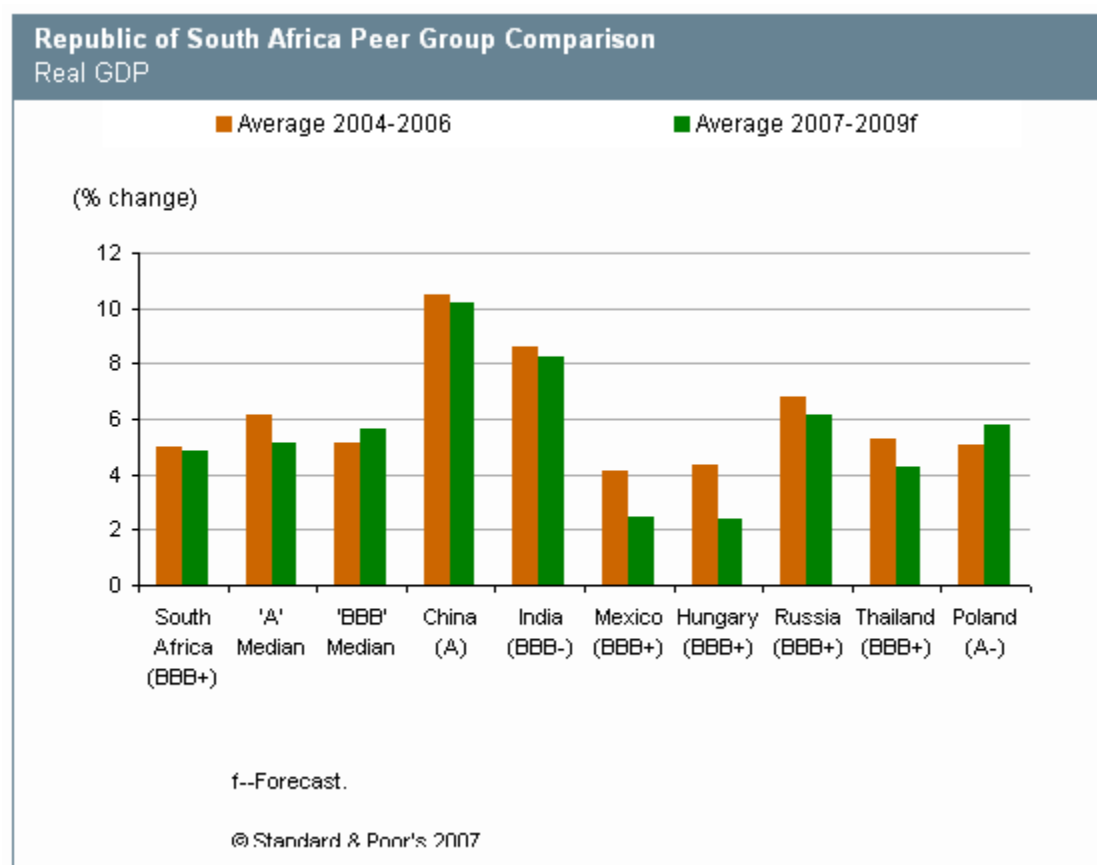


South Africa's Gini coefficient of income inequality is the worst of the peer group, at 57.8, according to 2007 World Development Indicators. Other poor performers include China (46.9) and Mexico (46.1). Hungary (26.9) and Poland (34.5) score highest among the peers. South Africa's social development challenges weigh on its creditworthiness, giving rise to long-term expenditure pressures while constraining revenues and economic growth. The risk of social frictions if inequalities persist in the long term is also more acute than for peers, partly due to the country's apartheid past, although demographic pressures and unbalanced growth are also daunting in India and China.

Growth push will keep current account deficit high

The South African economy is well diversified, similar to all peers apart from Russia, which is heavily reliant on hydrocarbons, and Mexico, where growth is highly correlated to U.S. economic expansion. Nevertheless, skills mismatches, microeconomic constraints, and low levels of investment have held back the pace of growth (see chart 2). Both public and private sector investment are set to increase in the coming years, mainly as a result of large infrastructure projects, which should help boost potential growth. The overall medium-term investment target of 25% of GDP resembles the 'BBB' and 'A' medians.

Chart 2



The planned increase in investment in South Africa will continue to fuel current account pressures, given that savings are currently below 15% of GDP. A deterioration in the trade balance, twinned with a structural deficit in invisibles, pushed the current account deficit above 6% of GDP in 2006, and it is expected to continue rising moderately in the medium term (see chart 3). This compares unfavorably with the 'BBB' and 'A' medians and all peers. Russia and China perform best in the group on external liquidity, thanks to booming hydrocarbon and merchandise exports, respectively, and rapid reserve accumulation.

Volatile flows dominate the financial account

Of the peers that record current account deficits, South Africa is the only one to also post small and erratic FDI coverage, relying instead on large portfolio equity inflows (see chart 4). A large current account deficit and uncertain external financing weighed on the rating on Hungary in recent years, but the external imbalance is now on a downward trend thanks to fiscal consolidation, while EU transfers are helping to supplement net FDI as a source of financing. The openness and sophistication of South Africa's capital markets have meant that, in past episodes of flight to quality, it has been one of the first emerging markets to be hit by ebbing portfolio flows. This was not the case in the summer of 2007, which reflects both investor confidence in South Africa's economic prospects, and atypical investor behavior due to the impact of subprime-related uncertainties on traditional safe havens. South Africa remains vulnerable to reversals in capital flows, but the potential impact of a correction is dampened by the rand's free-floating exchange rate.

Chart 3

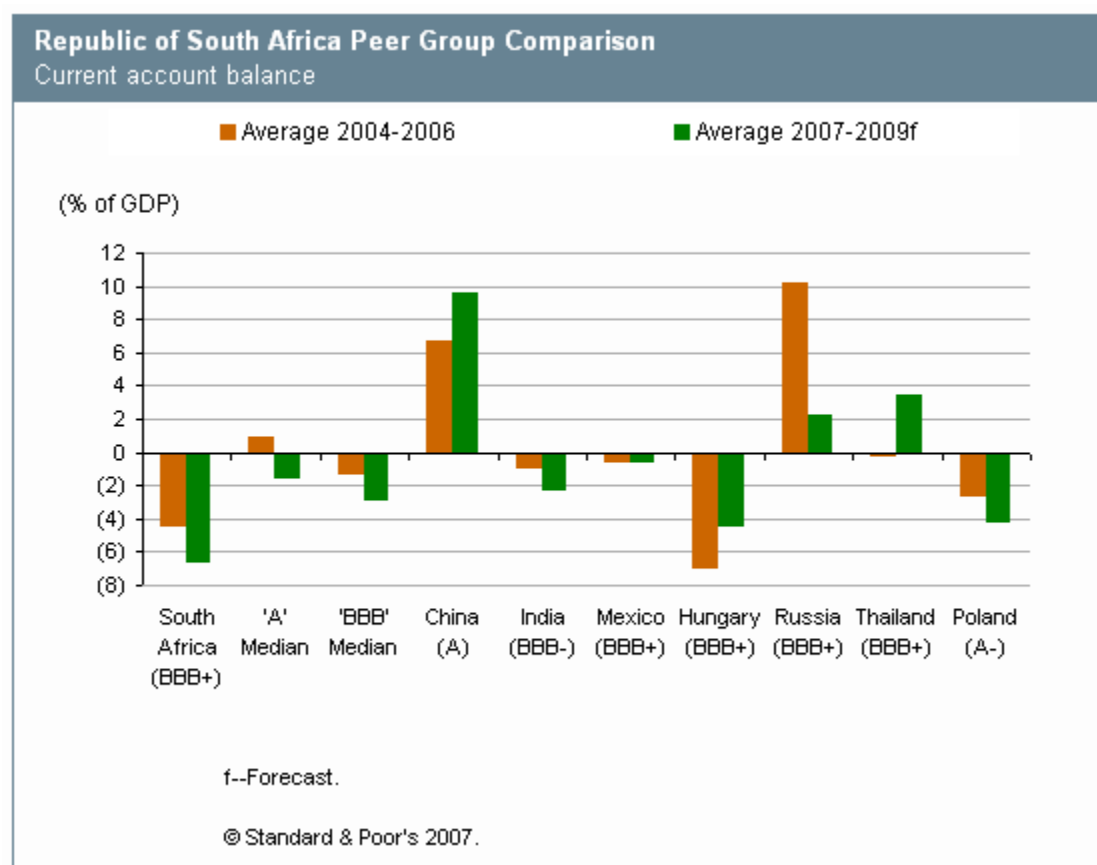
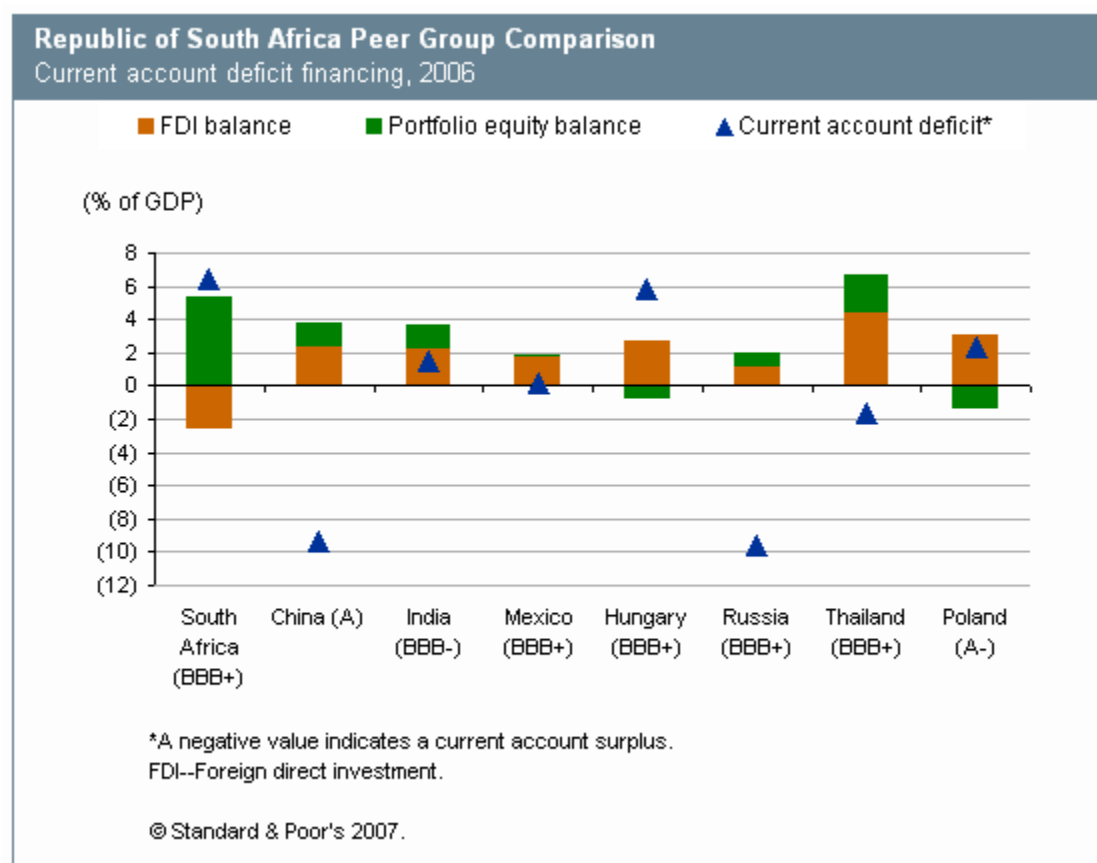


Chart 4



Fiscal management remains prudent

In South Africa, China, Mexico, Russia, and Thailand, fiscal positions close to balance will result in stable or even declining levels of net debt over the medium term. These peers also post moderate net debt levels in the first place, in contrast to India (74% of GDP in 2007) and Hungary (65%). Hungary will be the only peer to record a steadily increasing net debt trend over the period to 2010, although the country's significant tightening of its fiscal stance is slowing deterioration (see charts 5 and 6).

Chart 5

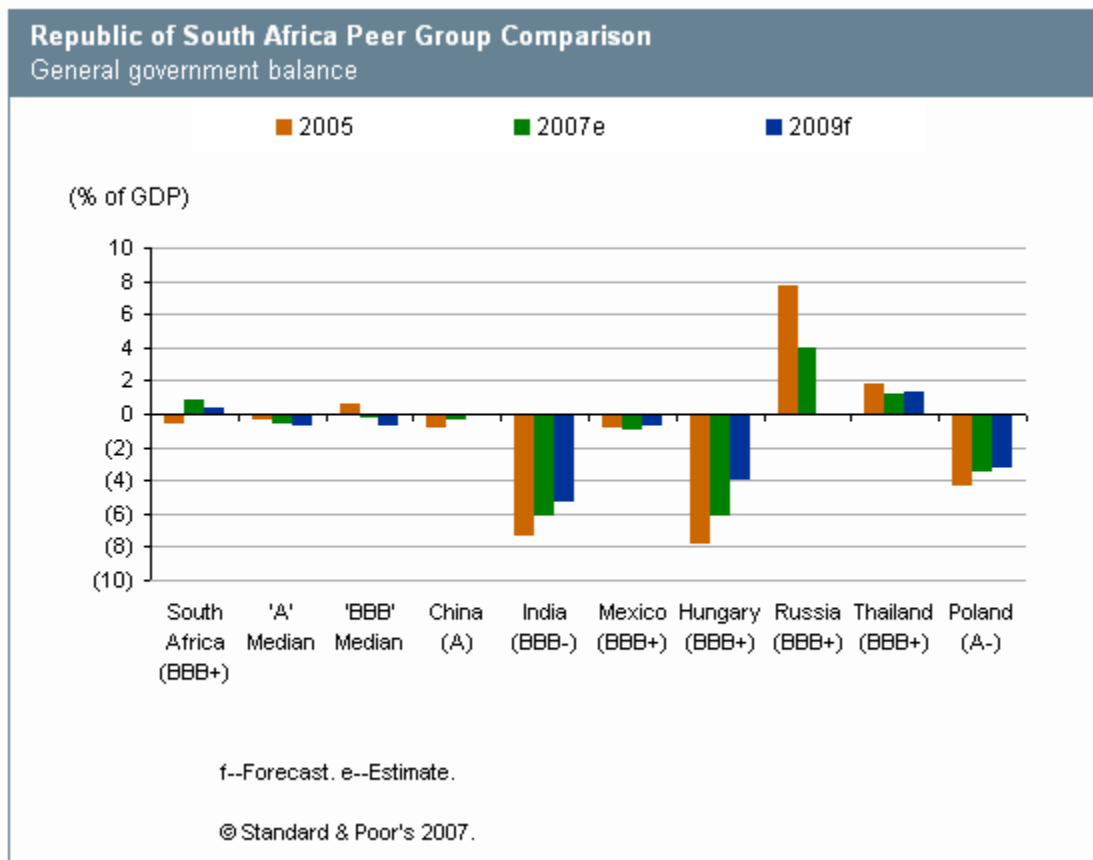
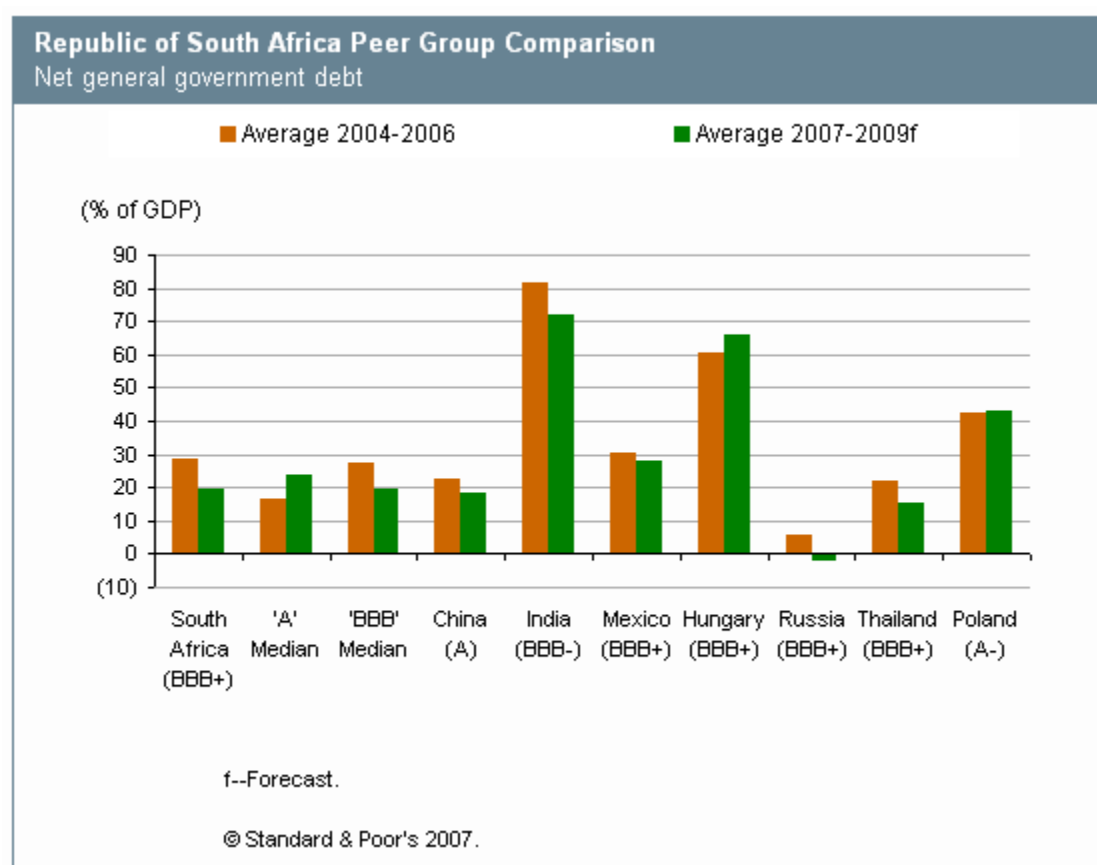


Chart 6



South Africa's fiscal flexibility is improving, on the back of a broadening revenue base. In this respect, it compares well with Russia and Mexico, which are reliant on petroleum revenue. Expenditure pressures are very significant, however, due both to the socioeconomic challenges mentioned above and to the public investment push in the years ahead. In the context of the rising current account deficit and above-target inflation since mid-2007, the government has so far managed to steer a prudent course and is expected to maintain a tight stance in the medium term. The responsiveness of fiscal management to policy-mix issues stands out among peers.

In contrast to South Africa, India's poor fiscal performance is compounded by large contingent liabilities at all levels of government. China and, to a lesser extent, Thailand and Russia, also face large contingent liabilities, particularly from the banking sector in the Chinese and Thai cases. Table 2 below shows South Africa's performance relative to peers in Standard & Poor's rankings of banking industry country risk. In a reasonable worst-case scenario, we estimate the problematic assets arising from banking sector difficulties at a maximum of 16% of GDP, comparing well within the peer group.

Table 2

Comparison Of Banking Industry Country Risk Assessments*			
	BICRA	GPA range (% of credit)	Contingent liability (% of 2007 GDP)
South Africa (BBB+)	5	10-20	16.4
China (A)	6	35-50	56.8
India (BBB-)	6	25-40	20.6

Table 2

Comparison Of Banking Industry Country Risk Assessments*(cont.)		
Mexico (BBB+)	4 15-30	5.9
Hungary (BBB+)	6 15-30	15.7
Russia (BBB+)	8 35-50	19.4
Thailand (BBB+)	6 35-50	45.6
Poland (A-)	6 25-40	14.3

*For more detail, see "S&P's Banking Industry Country Risk Assessments: Global Annual Roundup", published on RatingsDirect on Aug. 9, 2007. Banking Industry Country Risk Assessments (BICRAs) classify countries into 10 groups ranging from the strongest banking systems (Group 1) to the weakest (Group 10) from the perspective of country risk and overall creditworthiness of the banking sector (first column). A key component of each BICRA is an estimate of the potential proportion of credit that could become problematic during the full course of a recession; these estimates of gross problematic assets (GPAs) fall into six GPA ranges, the narrowest being 5%-15% and the widest 50%-75% (second column). The total contingent liability to the sovereign from the banking sector is expressed as the maximum GPA estimate multiplied by the size of credit relative to GDP (third column).

Political Environment: All Eyes On Leadership Transition

- Upcoming ANC and national elections present a short-term challenge, but major policy changes are not expected.
- Multiple social challenges have long-term ramifications for policy.

South Africa's political environment is broadly stable, with a lively and vocal press, independent judiciary, and growing civil society helping to counterbalance the power of the dominant ANC party. Official opposition parties are weak, but the variety of different constituencies that the ANC caters to serves as an internal system of checks and balances.

Short-term challenges during ANC and national elections

The main short-term risk to the political environment stems from the transition of power at the end of President Thabo Mbeki's second and final term of office. The transition will occur in two stages, with ANC leadership to be determined at its party conference in December 2007, and general elections following in 2009.

At the time of writing, Mbeki was still running for a third term as leader of the ANC, despite a much stronger performance by former Deputy President Jacob Zuma at preliminary nomination votes in late November 2007. Zuma's challenge, and his open antagonism with Mbeki, has lent a divisive atmosphere to the election campaign, but no third candidate has gained sufficient momentum to provide a credible compromise. There was speculation that Cyril Ramaphosa, best known as the ANC's chief negotiator in the early 1990s talks to end apartheid, might be able to step in at the last minute. This remains possible, but a Zuma victory appears increasingly likely.

If Mbeki reverses the situation and wins, the prospect of a decoupling of the ANC and Republic presidencies after 2009 raises some issues. On the positive side, Mbeki would be in less danger of being a "lame duck" president in the run-up to the 2009 elections. That said, two centers of power after 2009 could be destabilizing or even paralyzing.

Concern has been voiced that a Zuma victory could lead to more populist or left-wing policies, owing in part to the support he enjoys from the Congress of South African Trade Unions (COSATU) and the South African Communist Party. Standard & Poor's believes that a sharp and immediate change of policy direction would be unlikely, due in part to the policy anchor provided by the ANC's structures. Nevertheless, the prospect of a Zuma-Mbeki interregnum until the national election in 2009, as well as speculation regarding key appointments under Zuma, could lead to some volatility in sentiment within and outside South Africa.

Long-term social needs

South Africa's extensive welfare program and continued strong economic growth partly counterbalance the country's stark social challenges. Increasingly, however, the government is under pressure to ensure that the benefits of growth are spread throughout society, particularly through reduced unemployment and poverty.

Under the Accelerated Shared Growth Initiative For South Africa (Asgi-SA) framework, the government aims to reduce unemployment and poverty by one-half by 2014. This is ambitious, even if growth maintains its current trajectory, and management of expectations among the population will consequently be important. The return to the labor market of many erstwhile "discouraged workers" (who may number up to 14% of the workforce) is adding to unemployment pressures. The rate of job creation has been limited by skills shortages and by the subdued performance of sectors that might otherwise have soaked up large pools of unskilled and semiskilled labor, such as nonmineral tradables. High minimum wages in certain sectors and labor laws that involve protracted judgments are other obstacles to hiring.

Inequality, notwithstanding the rapid growth of the black middle class, remains strongly linked to racial differences. The government's Black Economic Empowerment (BEE) initiative continues to evolve in an effort to increase black participation in, and ownership of, the economy. However, skills shortages among the black population make the practical implementation of BEE difficult. Similarly, land reform has hitherto proceeded slowly and unevenly, prompting calls for a more concerted approach.

Economic Prospects: Sustained Effort To Boost Potential Growth

- South Africa is a middle-income country with a well-diversified economy.
- Economic growth has increased, but supply constrains further acceleration.

Table 3

Republic of South Africa Economic And Financial Indicators								
	2010f	2009f	2008f	2007e	2006	2005	2004	2003
Nominal GDP (bil. ZAR)	2,597.5	2,347.1	2,120.8	1,918.2	1,726.7	1,539.3	1,398.2	1,260.7
Nominal GDP (bil. \$)	422.4	366.7	321.3	280.4	255.1	242.0	216.4	166.7
GDP per capita (\$000s)	8.7	7.6	6.7	5.9	5.4	5.1	4.6	3.6
Real GDP (% change)	4.9	4.9	4.8	4.8	5.0	5.1	4.8	3.1
Real GDP per capita (% change)	4.4	4.4	4.3	4.3	4.5	4.6	4.2	2.3
Gross domestic investment (% of GDP)	21.0	20.5	20.0	19.7	19.6	18.3	17.7	16.9
Gross domestic savings (% of GDP)	15.1	14.5	13.9	13.5	13.3	14.5	14.5	15.8
Real exports (% change)	7.5	8.0	8.3	6.5	3.2	8.0	2.9	0.1
Consumer price index (% change)	5.0	5.3	6.1	6.0	4.6	3.9	4.3	6.8
Domestic credit to private sector and NFPEs (% change)	15.0	15.0	15.0	15.0	25.4	18.0	14.3	17.9
Domestic credit to private sector and NFPEs (% of GDP)	92.2	88.8	85.4	82.1	79.3	71.0	66.2	64.2

f--Forecast. e--Estimate. ZAR--South African rand. NFPE--Nonfinancial public enterprise.

Economic structure

South Africa is a middle-income country with a well-diversified economy. Primary industries account for about 10% of value added, with agriculture contributing less than 3% and mining the remainder. In recent years, the decline in gold production means that the benefits of high gold prices have not been exploited, weighing on mining

performance. Manufacturing accounts for close to 20% of value added, led by petroleum products, chemicals, rubber and plastic, metals, metal products, machinery and equipment, and food, beverages, and tobacco.

The tertiary sector contributes two-thirds of value added, and services are the driving force behind current growth. In the second quarter of 2007, private sector services accounted for 64% of real growth in value added (annualized); construction accounted for another 12%. Mainly finance, real estate, and business services fuel services growth. The construction sector's prospects remain robust, largely due to public sector investment plans and the continued high level (albeit slowing) of residential sector activity.

Economic growth

Economic growth has been impressive over the last three years, averaging nearly 5%. On the demand side, both public and private investment are likely to push 2007 growth, while private consumption falls amid higher interest rates and already high debt levels.

That said, supply constraints look likely to complicate attempts to reach an even higher growth trajectory. The most important of these are shortages of infrastructure and human capital. With official unemployment of 26%, the potential growth rate from labor accumulation alone should be significant, although severe skills shortages limit the impact. Growth is also curbed by HIV/AIDS, with the annual impact estimated at somewhere between 0.2% and 0.7% of GDP. Finally, the significant tightening in monetary policy over the past year may have an impact on medium-term growth.

Fiscal Flexibility: Debt Keeps Falling On Prudent Stance

- The fiscal stance is prudent despite spending pressures.
- General government debt is expected to continue falling.
- Off-budget and contingent liabilities are manageable.

Table 4

Republic of South Africa Fiscal Indicators								
(% of GDP)	2010f	2009f	2008f	2007e	2006	2005	2004	2003
Central government revenues	27.5	27.8	28.3	28.2	27.6	26.9	25.0	23.9
Central government expenditures	27.6	27.7	28.0	27.8	27.3	27.2	26.5	26.1
General government balance	0.3	0.4	0.6	0.9	0.6	(0.6)	(1.7)	(2.6)
Of which central government	0.0	0.1	0.3	0.4	0.3	(0.3)	(1.5)	(2.2)
Of which local authorities	(0.5)	(0.5)	(0.5)	(0.6)	(0.5)	(0.5)	(0.5)	(0.8)
General government primary balance	3.4	3.6	3.8	3.5	3.6	2.7	1.8	1.3
Central government primary balance	3.0	3.3	3.5	3.2	3.3	3.0	1.8	1.5
General government balance (% of revenues)	1.9	2.0	2.0	2.4	1.7	(1.8)	(5.3)	(8.5)
General government interest payments (% of revenues)	9.1	9.3	9.2	7.7	8.7	10.0	11.0	12.6
Central government interest payments (% of revenues)	11.5	11.7	11.6	9.7	11.0	12.3	13.3	15.6
General government debt	21.6	23.8	26.4	29.6	33.3	36.6	37.1	39.7
Of which central government debt	21.6	23.8	26.4	29.6	33.3	36.6	37.1	39.7
General government net debt	15.7	17.3	19.2	21.6	24.4	30.1	31.9	35.0
Of which central government net debt	15.7	17.3	19.2	21.6	24.4	30.1	31.9	35.0

f--Forecast. e--Estimate.

Revenue, expenditure, and balance performance

In fiscal 2006/2007, South Africa's central government budget performance exceeded expectations and recorded a surplus of 0.6% of GDP. This was driven in large part by higher revenues, themselves a result of more efficient tax collection and stronger-than-expected economic growth. Corporate taxes were particularly strong in 2006/2007, increasing by 25% over budget.

Expenditure was also slightly below its planned level in absolute terms due to the inability of local and provincial governments to fully spend their capital expenditure allocation. Local governments, provinces, and municipalities receive more than two-thirds of central government total revenues.

Small surpluses are expected in 2007/2008 and in the medium term, at both central and general government levels. These projections include allocations to a contingency surplus account, intended as a reserve to cover overruns in capital expenditures.

The authorities project real noninterest central government spending growth at an average of 6.4% in the period to 2010/2011, compared with 9.4% in the past five years. Revenue projections remain dynamic, but the ratio of central government revenue to GDP is expected to peak during the next two fiscal years, before declining in 2010/2011. This reflects a rebalancing of growth, as well as a moderation of revenue elasticity, which has been particularly high in the recent past. Although the National Treasury does not follow a formal fiscal rule, it has pledged to save part of the cyclical revenue windfall still to come, while channelling the rest toward productive investment.

This level of fiscal prudence is deemed appropriate in the short term, given the stage of the cycle that South Africa is in and the evolution of the current account deficit, as well as uncertainties over the near-term prospects for global growth, liquidity, and commodity prices. But significant spending pressures remain, particularly owing to chronic infrastructure shortages, high poverty levels, and health-related (primarily HIV/AIDS) challenges. Public sector investment is set to rise to about 8% of GDP, with infrastructure spending driven by Transnet Ltd. (transport; BBB+/Stable/--) and ESKOM Holdings Ltd. (electricity utility; BBB+/Stable/--). The 2010 Football World Cup, which South Africa will host, is adding to short-term investment pressures.

As regards social spending, currently more than 10 million people (nearly one-third of the adult population) receive social grants of one form or another. Some critics of the government contend that the BEE and other social policies are increasingly moving from a focus on equal access and opportunity toward expectations of equal wealth. Welfare policy, however, continues to focus principally on targeted assistance for vulnerable groups.

Government debt and interest

Continued fiscal prudence has contributed to falling general government debt, which stood at an estimated 29% of GDP at the end of fiscal 2006/2007 compared with 39% in 2001/2002. The interest burden represented about 3% of GDP in 2006/2007. In the same year, foreign currency debt amounted to about 14% of total debt, dominated by the euro (47%), the U.S. dollar (37%), and the yen (9%). The broader public sector (including state-owned enterprises) will have a borrowing requirement of 1.2% of GDP by 2010/2011 (compared with a surplus of 0.2% of GDP in 2006/2007) owing to aggressive investment plans by the nonfinancial public enterprises (NFPEs).

Off-budget and contingent liabilities

Explicit government guarantees amounted to ZAR68 billion in 2005/2006, down from ZAR80 billion in 2003/2004, with Transnet accounting for the largest proportion. Standard & Poor's estimates the fiscal cost of a reasonable worst-case banking sector crisis at 16% of GDP. The key risk to the sector arises from rapidly increasing

household leverage, reflected in record levels of household debt, at 74% of disposable income in 2006. This risk is mitigated by historically low borrowing costs, despite recent interest rate rises. Thus far, credit growth has not led to noticeable increases in nonperforming loans in the banking sector. The government and central bank continue to develop their prudential framework, and the National Credit Act (NCA) introduced in June 2007 aims to strengthen lending decisions and limit the extent to which relatively financially illiterate new borrowers can get into debt problems, with an expected dampening impact on credit growth.

Monetary Policy: Central Bank Tightens The Reins

- The SARB, whose goal is the achievement and maintenance of price stability, has tightened monetary policy amid heightened inflationary pressure.
- Exchange rate volatility remains a background risk, but the rand was largely insulated from the global market turbulence of summer 2007.

Monetary policy has tightened considerably

The second half of 2006 witnessed increases of 200 basis points (bps) in the SARB repo rate. The Monetary Policy Committee added a further 200 bps to the rate by early December 2007, bringing it to 11%. CPIX (CPI excluding mortgage interest payments) first breached the 3%-6% band in April 2007 (reaching 6.3%) and has remained stubbornly high despite the tightening credit conditions.

Food prices (owing to the adverse impact of drought on the maize harvest) and rising energy prices are fueling inflationary pressures in the economy. Credit growth has also been a factor, although all elements of private sector credit growth (except for mortgages) have slowed since the 2006 interest rate rises.

The introduction of the NCA in June 2007 is expected to further moderate credit growth. Unit labor cost growth has also been low due to moderate wage settlements and improvements in productivity. Nevertheless, there is significant wage pressure in the economy, with the government projecting average wage settlements at more than 7.0%-8.0% in 2007, compared with 6.5% in 2006. Meanwhile, the ongoing public investment program could add to inflationary pressures.

Exchange rate volatility remains a risk

The rand tends to be vulnerable to changes in investor sentiment, due to its liquidity, its use for proxy emerging market trades, and recently, the substantial current account deficit. From January to September 2006, the rand depreciated by 20% against the dollar, precipitated by the temporary global reappraisal of risk premiums in May 2006. In contrast, the global market turbulence during summer 2007 has not had a lasting impact on the currency, in line with the broad resilience of emerging markets during this period. Nevertheless, at the time of writing, the full effects of the global market difficulties set in motion during the summer remain uncertain, leaving the rand vulnerable to increased volatility. A further source of uncertainty lies in the effect of the evolving political situation on investor sentiment.

The pass-through to domestic inflation from the weaker rand since mid-2006 was noticeably lower than in previous depreciation episodes. This has been attributed to various offsetting effects (such as the increased presence of cheap Chinese imports or competitive pressures that force companies to absorb price changes into their margins), as well as increased credibility of monetary policy.

External Finances: Higher Imbalance Is Here To Stay

- The current account deficit is not likely to decline significantly in the medium term.
- Portfolio inflows finance the imbalance, creating potential exposure to changes in investor sentiment.
- Total external debt, net of the most liquid assets, is moderate.

Table 5

Republic of South Africa External Indicators								
	2010f	2009f	2008f	2007e	2006	2005	2004	2003
(% of GDP)								
Current account balance	(7.5)	(7.2)	(6.7)	(6.5)	(6.4)	(3.8)	(3.2)	(1.1)
Trade balance	(3.6)	(3.2)	(2.5)	(2.2)	(2.4)	(0.5)	(0.1)	2.1
Net foreign direct investment	0.7	0.7	0.7	0.7	(2.6)	2.2	(0.3)	0.1
(% of CARs)								
Current account balance	(20.9)	(20.3)	(19.4)	(19.4)	(19.9)	(12.8)	(11.4)	(3.8)
Net external liabilities	101.7	82.0	71.3	62.6	52.9	50.0	35.3	27.7
Total external debt	61.6	63.7	66.6	70.6	71.1	61.9	67.0	73.0
General government external debt	24.5	27.1	30.3	33.0	34.0	31.7	38.8	43.1
Narrow net external debt*	21.5	19.3	17.7	15.7	10.0	1.7	10.2	20.3
Net public sector external debt	2.4	1.9	1.5	(0.1)	(4.6)	0.2	12.1	24.9
Net nonbank private sector external debt	3.9	3.5	3.2	4.1	4.4	0.1	(3.4)	0.4
Net banking sector external debt	(2.2)	(4.6)	(7.2)	(10.2)	(13.0)	(16.3)	(18.6)	(22.9)
Net investment payments	6.6	6.6	7.2	7.4	6.5	6.9	7.0	9.2
Net interest payments	2.1	1.9	1.7	1.3	1.0	1.0	1.7	2.2
Reserves/CAPs (months)	1.9	2.1	2.3	2.7	2.5	2.2	1.5	1.8
Gross external financing needs (% of CARs and usable reserves)	122.1	120.5	117.1	114.8	114.3	108.3	115.5	110.4

*Narrow net external debt is defined as the stock of foreign and local currency public and private sector borrowings from nonresidents (including nonresident deposits in resident banks) minus liquid nonequity external assets, which include official foreign exchange reserves, other liquid public sector foreign assets, and financial institutions' deposits with and lending to nonresidents. A negative number indicates net external lending. f--Forecast. e--Estimate. CARs--Current account receipts. CAPs--Current account payments.

External liquidity

The deterioration in the trade balance since 2004 has meant there has been no counterweight to the structural deficit in the services, income, and transfers accounts. In 2006, the trade deficit widened to 2.4% of GDP, from a surplus of 4.3% of GDP as recently as 2002. This resulted in an overall current account deficit of 6.4%. Dynamic import growth is driving the trade deficit. In particular, capacity constraints amid the investment boom mean that South Africa is now importing products it used to export, such as steel and cement.

The manufacturing sector (particularly the car industry) has recorded robust export growth, even though the rand's recent relative strength (notwithstanding significant nominal depreciation in 2006) has weighed on the performance of noncommodity tradables. With ongoing elevated oil prices, the strength of the domestic economy, and a strong investment pipeline, the current account deficit is likely to remain high until at least 2010.

Of the major invisibles transactions, net income payments are generated by large outflows of dividends, while the deficit in the transfers account is largely the result of South Africa's payments to members of the Southern African

Customs Union (to share customs and excise revenues and provide development aid). These payments have increased to 1% of GDP in 2006, from 0.5% of GDP in 2002, and slightly distort the interpretation of the current account as they do not imply a need for foreign financing. Instead, the payments are made in rands and are likely to remain in rands because of significant exchange rate management against the rand in the recipient countries, and their high levels of trade with South Africa.

The current account deficit also reflects an excess of investment versus savings. Investment currently stands at 20% of GDP, and the government hopes to increase this to 25% as part of its growth strategy. Investment contrasts with a low level of savings of less than 14% of GDP. Savings by households have recently fallen due to debt-driven expenditures, while corporations have increased their dividend and tax payments. Without significant changes in the savings ratio, the financing of the current account deficit will remain a key component in any analysis of the sovereign's creditworthiness.

Net FDI contributes little to external financing, with significant outflows from South African companies, as well as developed local markets providing the opportunity for foreign companies to fund themselves domestically rather than bringing foreign exchange. Inflows have also been discouraged by rand volatility and a history of high inflation, as well as lower trade openness, concerns about crime and the economic impact of the HIV/AIDS pandemic, the perception of government intervention (through BEE for example), and a shortage of large privatizations. That said, higher levels of M&A activity in South Africa, and particularly the increased interest of private equity in the South African market, may spur higher FDI in the future.

Portfolio inflows currently fund the deficit, particularly those into the Johannesburg stock exchange (JSE), where foreign capital now represents about one-fifth of total capitalization. The central bank has consequently increased reserves to over \$27 billion currently, and prepaid some external debt, thereby mitigating external liquidity vulnerabilities. However, these inflows are by nature unpredictable. A change in global market sentiment could reduce inflows, in turn triggering a rand correction and probable tightening of monetary policy.

Narrow net external debt

External debt has continued to fall, which is particularly important given South Africa's external liquidity exposure. In 2006/2007, the authorities took advantage of favorable exchange rates to prepay a foreign loan of \$263 million. The government does not plan to borrow in the international capital markets over the next couple of years and as a result, its external debt is set to fall to 27% of CARs by 2009/2010, from 34% currently. An increasing share of external debt is denominated in rands (20% of rand-denominated debt is held by non-residents), which also mitigates the risk to borrowers from rand depreciation.

Narrow net external debt is moderate, at 16% of CARs, though climbing steadily as foreign holdings of domestic debt securities rise. A portion of South Africa's investment plans will also be financed by foreign debt, contributing to the increase in coming years.

Ratings Detail (As Of December 7, 2007)*

South Africa (Republic of)

Sovereign Credit Rating

Foreign Currency

BBB+/Stable/A-2

Local Currency

A+/Stable/A-1

South African National Scale

zaAAA/--/zaA-1

Ratings Detail (As Of December 7, 2007)*(cont.)		
Senior Unsecured		
Foreign Currency		BBB+
Local Currency		A+
Short-Term Debt		
Foreign Currency		A-2
Sovereign Credit Ratings History		
01-Aug-2005	Foreign Currency	BBB+/Stable/A-2
07-May-2003		BBB/Stable/A-3
12-Nov-2002		BBB-/Positive/A-3
01-Aug-2005	Local Currency	A+/Stable/A-1
07-May-2003		A/Stable/A-1
12-Nov-2002		A-/Positive/A-2
29-Mar-2006	South African National Scale	zaAAA/--/zaA-1
Default History		
Default on foreign currency bank debt: 1985-1987, 1989, and 1993.		
Population		47.9 million
Per Capita GDP		\$5,857
Current Government		
President Thabo Mbeki heads a majority African National Congress (ANC) government.		
Election Schedule		
National legislative elections		
Last: April 2004		
Next: 2009		

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

Additional Contact:

Sovereign Ratings; SovereignLondon@standardandpoors.com

Additional Contact:

Sovereign Ratings; SovereignLondon@standardandpoors.com

Copyright © 2008, Standard & Poors, a division of The McGraw-Hill Companies, Inc. S&P and/or its third party licensors have exclusive proprietary rights in the data or information provided herein. This data/information may only be used internally for business purposes and shall not be used for any unlawful or unauthorized purposes. Dissemination, distribution or reproduction of this data/information in any form is strictly prohibited except with the prior written permission of S&P. Because of the possibility of human or mechanical error by S&P, its affiliates or its third party licensors, S&P, its affiliates and its third party licensors do not guarantee the accuracy, adequacy, completeness or availability of any information and is not responsible for any errors or omissions or for the results obtained from the use of such information. S&P GIVES NO EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE. In no event shall S&P, its affiliates and its third party licensors be liable for any direct, indirect, special or consequential damages in connection with subscriber's or others' use of the data/information contained herein. Access to the data or information contained herein is subject to termination in the event any agreement with a third-party of information or software is terminated.

Analytic services provided by Standard & Poor's Ratings Services (Ratings Services) are the result of separate activities designed to preserve the independence and objectivity of ratings opinions. The credit ratings and observations contained herein are solely statements of opinion and not statements of fact or recommendations to purchase, hold, or sell any securities or make any other investment decisions. Accordingly, any user of the information contained herein should not rely on any credit rating or other opinion contained herein in making any investment decision. Ratings are based on information received by Ratings Services. Other divisions of Standard & Poor's may have information that is not available to Ratings Services. Standard & Poor's has established policies and procedures to maintain the confidentiality of non-public information received during the ratings process.

Ratings Services receives compensation for its ratings. Such compensation is normally paid either by the issuers of such securities or third parties participating in marketing the securities. While Standard & Poor's reserves the right to disseminate the rating, it receives no payment for doing so, except for subscriptions to its publications. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.

Any Passwords/user IDs issued by S&P to users are single user-dedicated and may ONLY be used by the individual to whom they have been assigned. No sharing of passwords/user IDs and no simultaneous access via the same password/user ID is permitted. To reprint, translate, or use the data or information other than as provided herein, contact Client Services, 55 Water Street, New York, NY 10041; (1)212.438.9823 or by e-mail to: research_request@standardandpoors.com.