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South Africa (Republic of)

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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+/Negative/A-2
Local Currency A+/Negative/A-1
South African National Scale zaAAA/--/zaA-1

Rationale

The ratings on South Africa are supported by its prudent macroeconomic policies, a moderate debt burden, and stable political institutions. These are balanced by continued high reliance on external portfolio inflows in the context of a large current account deficit, and severe structural socioeconomic weaknesses. In particular, pressures on South Africa's balance of payments increase the risk of further currency depreciation and a sharper-than-anticipated correction in the current account deficit, with attendant effects on prospects for trend growth and fiscal outturns.

The global financial turmoil has contributed to a sharp depreciation of the South African rand since the beginning of 2008. We expect net portfolio flows to remain negative on average in the short term. Combined with a current account deficit expected at 22% of current account receipts in 2008, this should result in further rand weakness in the coming months. This will prolong inflationary pressures and delay monetary easing, at a time when growth is slowing rapidly in response to high interest rates, supply constraints, the commodity downturn, and dwindling external demand.

Part of the necessary adjustment in the balance of payments is increasingly likely to occur via a larger-than-anticipated correction in domestic demand, including through the delaying of public sector investments. In turn, that would feed through into a more protracted period of GDP growth below the 4%-5% trend growth seen before this year, with ramifications for fiscal revenue dynamics. A deep and protracted slowdown would also add to policy pressures on the government following the upcoming general election.

After running surpluses close to 1% of GDP for the past two fiscal years, our base case is for the general government to return to deficits in the region of 2% of GDP for the next two years, and to remain in deficit in the period to 2011/2012. This assumes that the political transition does not result in a major shift in the fiscal-monetary policy mix in the current sensitive balance-of-payments juncture.

South African banks have had limited exposure to the effects of the deleveraging in developed banking sectors, and they should weather deteriorating asset quality at home as the cycle continues to turn and households repair their

balance sheets. As a result, the sovereign's exposure to global developments is primarily of a macroeconomic nature.

Outlook

The negative outlook reflects the increasing weight of short-term macroeconomic risks to our base case. An orderly correction of the balance of payments and continued responsiveness to the risks associated with it, combined with continued prudent fiscal policies and an enduring commitment to growth-enhancing microeconomic reforms beyond the 2009 general election, would support the ratings. In the context of the turbulent global markets, however, a loosening of macroeconomic policies would put downward pressure on the ratings.

Table 1

Republic of South Africa Selected Indicators									
	2004	2005	2006	2007	2008e	2009f	2010f	2011f	Median BBBs
GDP per capita (\$)	4,544	5,055	5,325	5,777	5,536	4,687	5,416	6,514	9,410
Real GDP (% change)	4.9	5.0	5.4	5.1	3.2	1.9	3.5	4.0	4.2
Real GDP per capita (% change)	3.9	4.1	4.7	3.6	1.7	0.4	2.0	2.5	3.6
General government balance (% of GDP)	(1.6)	(0.2)	0.8	1.1	(0.5)	(2.0)	(2.0)	(1.5)	(1.1)
General government debt (% of GDP)	36.4	35.3	33.1	28.6	26.4	26.0	25.9	25.3	29.8
Net general government debt (% of GDP)	31.1	28.8	24.3	20.2	18.8	19.1	19.5	19.4	26.3
General government interest expenditures (% of revenues)	11.2	9.9	8.8	8.1	8.1	7.6	7.3	7.2	6.1
Domestic credit to private sector and NFPEs* (% of GDP)	66.4	70.9	78.7	83.9	87.3	85.7	86.7	87.4	63.5
Consumer price index (average; % change)	4.3	3.9	4.6	6.5	12.0	8.5	6.7	5.0	7.5
Gross external financing needs (% of CARs and usable reserves)	118.5	114.0	115.9	117.2	114.7	112.7	110.9	113.1	111.4
Current account balance (% of GDP)	(3.2)	(4.0)	(6.4)	(7.3)	(7.6)	(7.0)	(6.3)	(6.9)	(4.3)
Narrow net external debt (% of CARs)¶	10.6	1.6	2.0	2.0	16.0	27.2	28.5	26.9	17.1

*Standard & Poor's estimates that, in a reasonable worst-case scenario, the government's contingent liability from a banking crisis could amount to 20% of bank credit; see Appendix 3 in "S&P's Banking Industry Country Risk Assessments: Global Annual Roundup," published on Aug. 9, 2007, on RatingsDirect, the real-time Web-based source for Standard & Poor's credit ratings, research, and risk analysis. ¶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. §The median data is for 2008. f--Forecast. e--Estimate. NFPEs--Nonfinancial public enterprises. CARs--Current account receipts.

Comparative Analysis

- Political institutions compare favorably with peers, although socioeconomic pressures on policy are substantial.
- Current account deficits are high. They are typically financed by short-term, predominantly non-debt-creating inflows, but this in turn exposes the currency to volatility on the financial account.
- 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 pressures, such as the Republic of India (BBB-/Stable/A-3; all ratings herein refer to foreign currency ratings) and People's Republic of China (A+/Stable/A-1). The Kingdom of Thailand (BBB+/Negative/A-2), the United Mexican States

(BBB+/Stable/A-2), The Russian Federation (BBB/Negative/A-3), the Republic of Hungary (BBB/Negative/A-3), and 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. This contrasts favorably with the concentration of power characteristic in China under the Communist Party, and in Russia under President Vladimir Putin and his successor, Dmitry Medvedev.

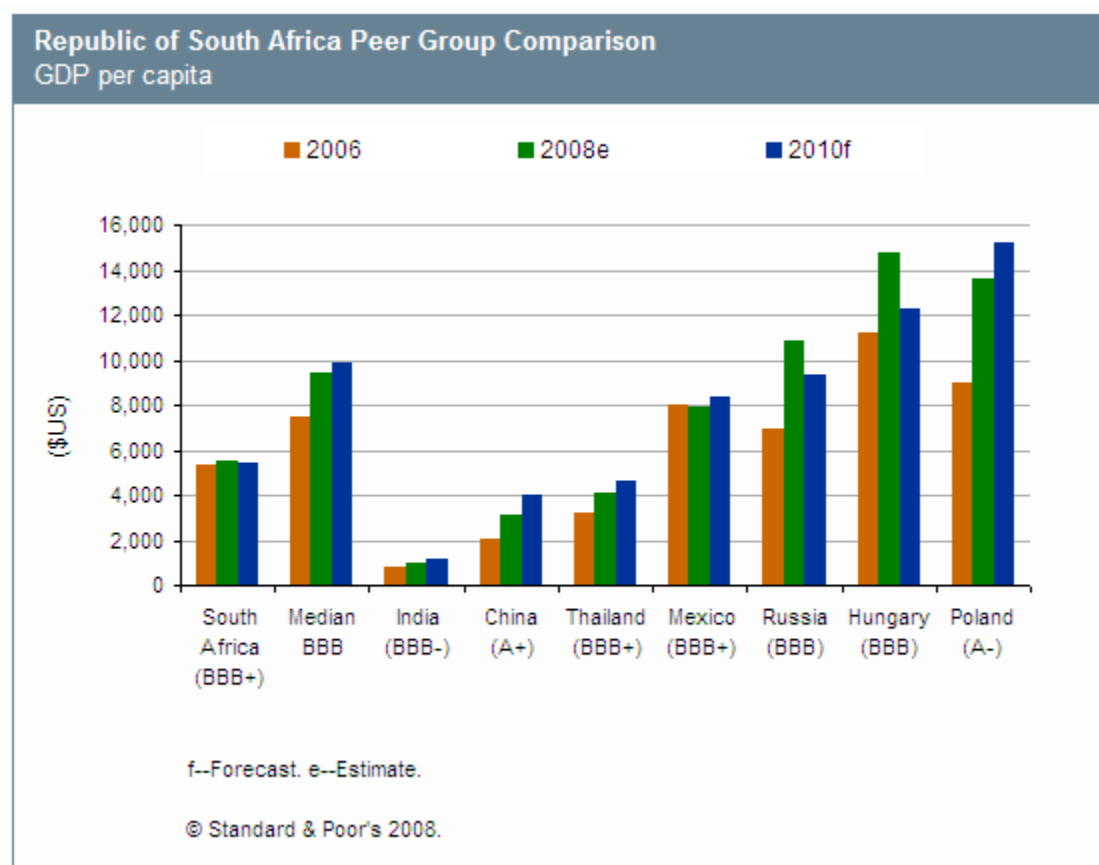
South Africa has been remarkably successful in treading a fine line between macroeconomic prudence and the need for rapid socioeconomic improvements. China presents some parallels, although policies there have encouraged faster but more unbalanced growth. The policy framework in Hungary and Poland is anchored by EU membership and the goal of Eurozone entry. That said, the degree to which this sets these two countries apart is questionable, as the period since they joined the EU has actually been marked by reduced policy 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 periods of political polarization and/or unwieldy coalitions. This reduces predictability on the policy front.

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 issues, 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 issues are comparable to those facing India (128), but much more substantial than for other peers such as China (81), Thailand (78), and Mexico (52). Poland (37) and Hungary (36) are the best-performing peers.

Chart 1



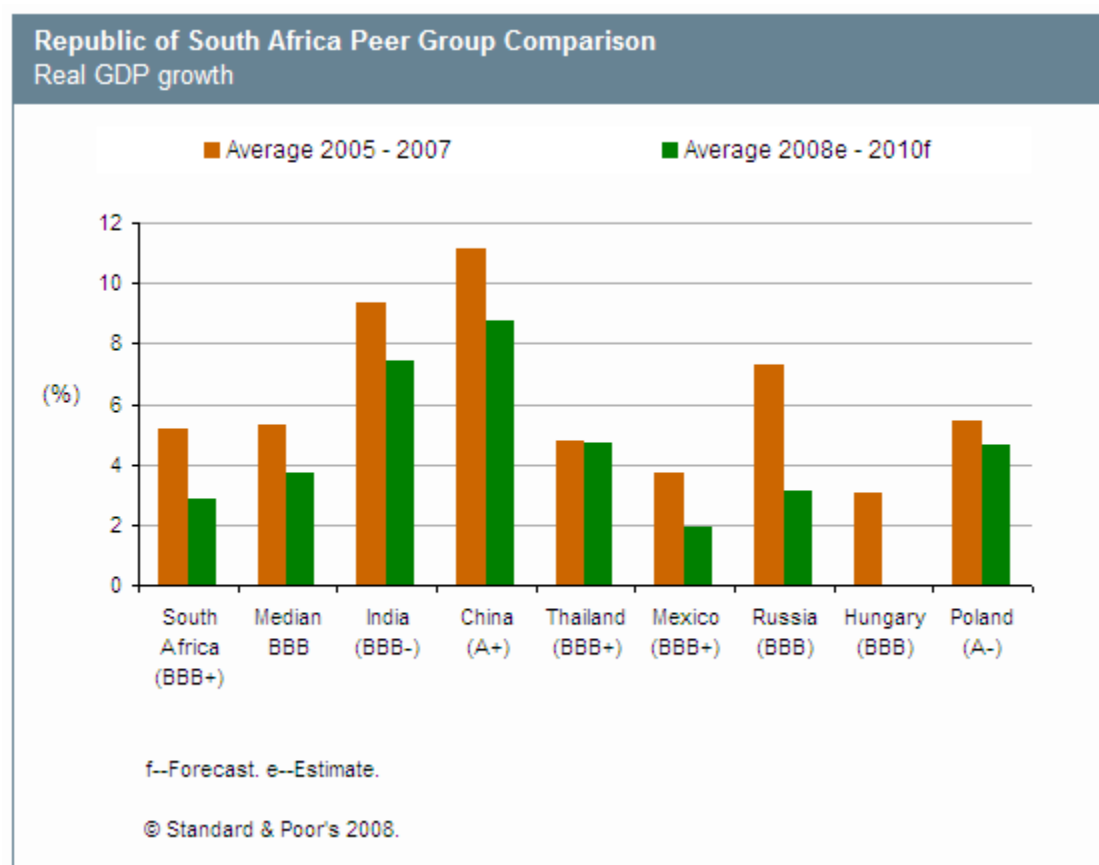
South Africa's Gini coefficient of income inequality is the worst of the peer group, at 57.8, according to 2007 World Development Indicators. Other poor performers include China (46.9) and Mexico (46.1). By contrast, Hungary (26.9) and Poland (34.5) score best among the peers.

The development issues faced by South Africa weigh on its creditworthiness, giving rise to long-term expenditure needs and, as evidenced by an outbreak of violence in poor urban areas in May 2008, social pressures. At the same time, they constrain economic growth and revenue potential. 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.

Current account deficit remains high

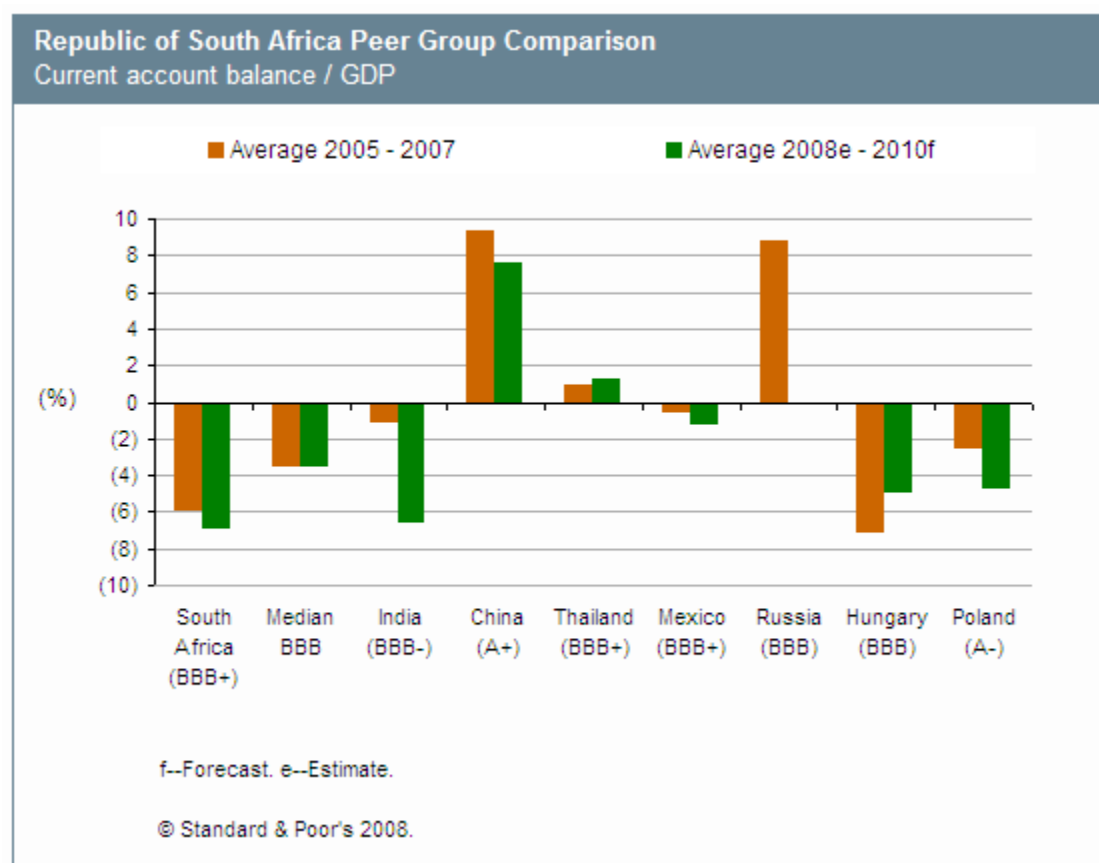
The South African economy is well diversified, similar to that of all peers apart from Russia, which is heavily reliant on hydrocarbons, and Mexico, where growth is highly correlated to U.S. economic expansion. Nevertheless, skills mismatches, microeconomic constraints, and low levels of investment have held back the pace of growth (see chart 2). Ongoing public investment projects, particularly into energy provision, should help boost potential growth beyond the forecast period. South Africa's overall medium-term investment target of 25% of GDP resembles the 'BBB'.

Chart 2



The investment push in Africa will continue to fuel current account pressures, given that savings are currently below 15% of GDP. A deterioration in the trade balance, combined with a structural deficit in invisibles, pushed the current account deficit above 7% of GDP in 2007. It is expected to remain above 7% in 2008-2009 (see chart 3). This compares unfavorably with the 'BBB' median and most peers, and exposes South Africa to a balance-of-payments correction.

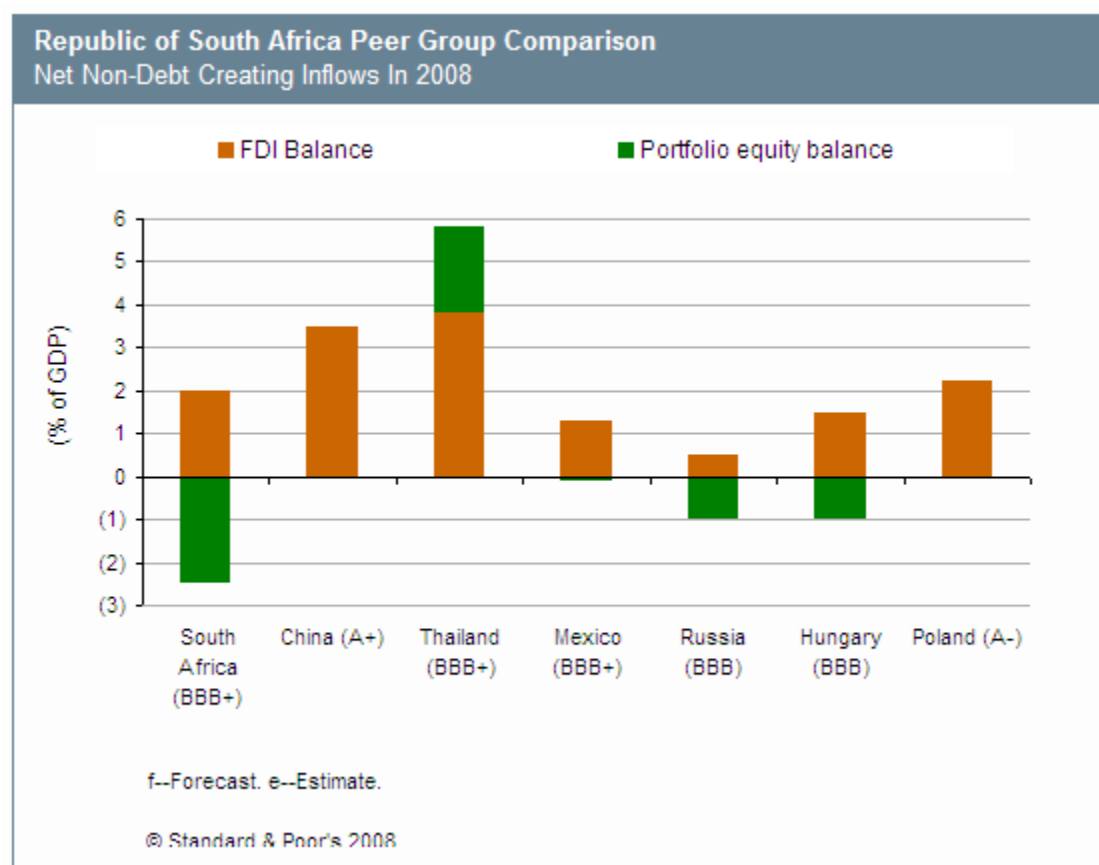
Chart 3



Balance of payments hits external financing constraints

Of the peers that record current account deficits, South Africa is the only one to also post small and erratic foreign direct investment (FDI) coverage, relying instead on large portfolio equity inflows--although 2007 was a partial exception to this trend (see chart 4). A large current account deficit and uncertain external financing have also weighed on the rating on Hungary in recent years which, in contrast to South Africa, also posts high external debt. Hungary was downgraded to 'BBB' from 'BBB+' on Nov. 17, 2008, reflecting its vulnerability to weakening international risk appetite, due to dependence on external financing inflows and the high stock of government debt.

Chart 4



The openness and sophistication of South Africa's capital markets have meant that, in past episodes of the flight to quality, it has been one of the first emerging markets to be hit by ebbing portfolio flows. Likewise, South Africa has felt the effects of ebbing capital flows since the end of 2007, and particularly since the final quarter of 2008. The impact of balance-of-payments adjustments is dampened by the rand's free-floating exchange rate, although sustained depreciations in turn complicate the task of monetary policy. The rand depreciated by more than 30% against the dollar in the year to December 2008. In the context of the current global downturn and flight to liquidity, depreciation is unlikely to re-price South African assets to a sufficiently attractive level to restore the financial account surplus for some time. As a result, external financing constraints may lead to a sharper-than-anticipated domestic demand slump instead.

Fiscal management remains prudent

In South Africa, China, Mexico, 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 posted moderate net debt levels in the first place, in contrast to India (68% of GDP in 2008) and Hungary (69%). Hungary will be the only peer to record an increasing net debt trend over the forecast period, as it draws down from an IMF-EU rescue package (see charts 5 and 6).

Chart 5

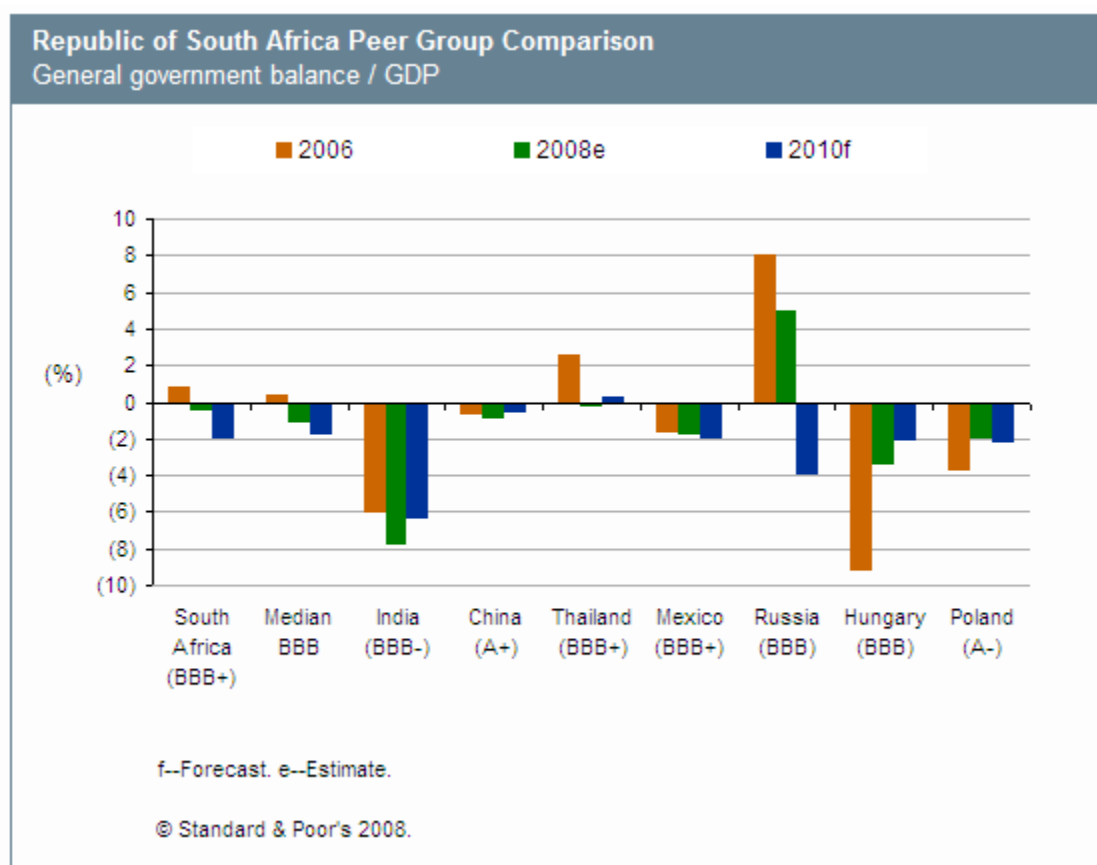
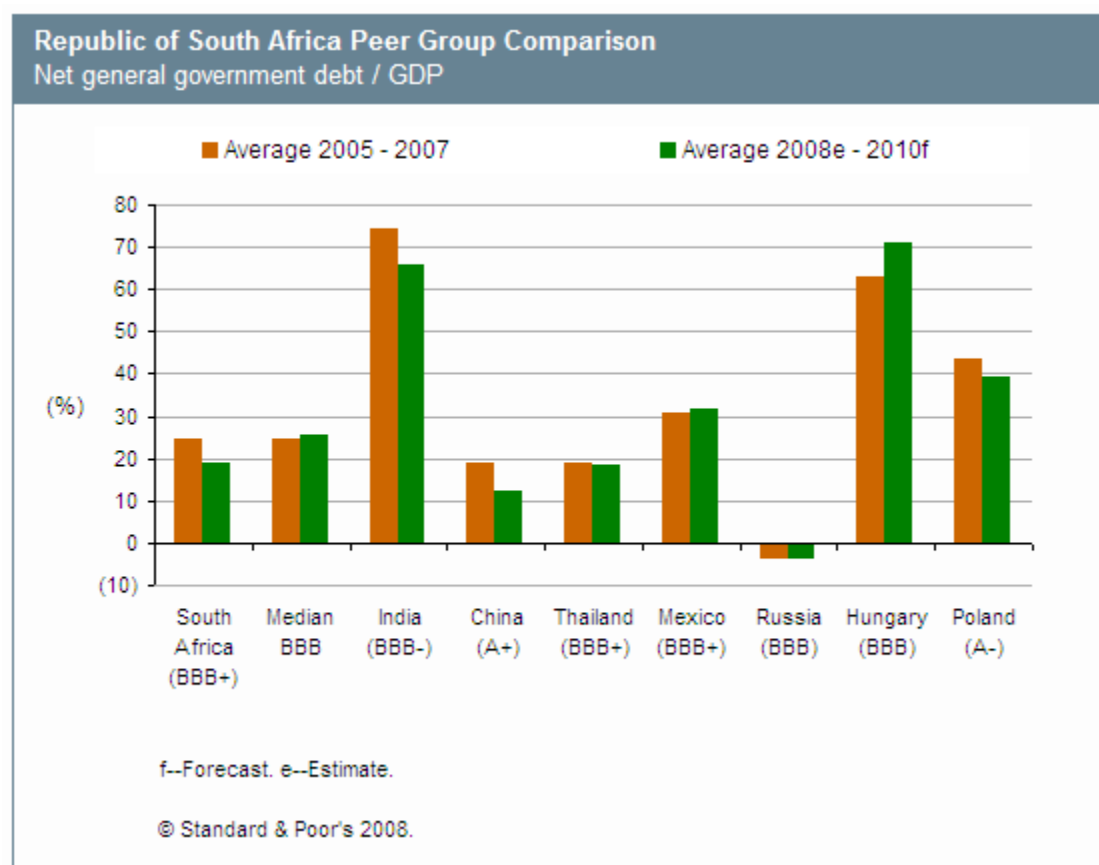


Chart 6



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 revenues. Expenditure pressures are significant, however, due both to the socioeconomic issues mentioned above and to the public investment push in the years ahead. In the context of the high 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 prudent stance in the medium term, despite some countercyclical loosening. 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 their banking sectors. In a reasonable worst-case scenario, we estimate the problematic assets arising from banking sector difficulties at a maximum of 18% of GDP for South Africa, which compares well with the peer group.

Political Environment: No Sharp Policy Change Expected

- The resignation of President Thabo Mbeki has enabled a more orderly transition of power to the new ANC leadership prior to the Spring 2009 general election. A new splinter party is being formed due to continued ANC tensions, but this is unlikely to challenge the ANC's dominance in the foreseeable future.

- Despite left-wing rhetoric and a greater focus on improved public service delivery, we expect that ANC policies will in practice remain economically prudent, due both to party checks-and-balances and to the rand's exposure to market sanction.
- Multiple social challenges have long-term ramifications for policy.

South Africa's political environment is 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 to which the ANC caters--including prominent business-persons--serves as an internal system of checks-and-balances. The ANC's democratic credentials were also strengthened by its recent hotly contested leadership election, introducing greater competition and accountability in party processes.

Policy direction remains on auto-pilot for now

President Thabo Mbeki's bid for a third term as ANC leader was decisively thwarted by his former deputy president Jacob Zuma at the ANC conference held in Polokwane in December 2007. The composition of the ANC's National Executive Committee and its associated structures also saw significant turnover, with the Mbeki camp suffering large losses. Following the invalidation of corruption and other charges hanging over Mr. Zuma, tensions between the two ANC camps came to a head, leading to Mr. Mbeki's resignation from the presidency in September 2008.

Mr. Zuma not being a member of parliament, ANC Deputy President Kgalema Motlanthe was selected to replace Mr. Mbeki until the general election scheduled for Spring of 2009. After resigning for procedural reasons, Finance Minister Trevor Manuel was reappointed by Mr. Motlanthe, pointing to an awareness in top ANC ranks of the need for policy steadiness, to prevent political risk exacerbating balance-of-payments pressures. The change of president provides an opportunity for the new guard at the ANC to settle into governance gradually, which should somewhat defuse politics-related market movements at the time of the election.

Following Mr. Mbeki's departure, a number of ANC figures not from Mr. Zuma's camp left the ANC to form a new party, named Congress of the People. This is expected to compete for middle-class black voters in particular, but appears unlikely to make a large impact at the Spring 2009 election.

Major shift to the left remains unlikely

Concern has been voiced that a Zuma presidency could lead to more 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, as well as an outburst of violence against immigrants in poor urban areas in May 2008. Although we think fiscal deficits will be slightly larger than currently projected, this is not unwarranted in the current downturn, and we do not anticipate a major shift to the left. First, any major deviation from the current macroeconomic framework is circumscribed by the economy's exposure to market sanction. Second, the ANC camp that won at Polokwane is not a solid bloc: it was united by its opposition to a third Mbeki term, and is less likely to unite behind radical policy shifts, particularly owing to the presence of high-profile business-persons on the ANC National Executive Committee, and the growing links between business and politics in South Africa over recent years.

Within the parameters of the current macroeconomic policy framework, changes are likely to focus first and foremost on governance and implementation. It appears likely that the Treasury will lose some of its influence on other ministries' substantive policy direction to a mooted planning body, while retaining control of the purse strings. In parallel, there is likely to be a greater focus on delivering better outcomes on issues of crime, employment creation, public services, and the effectiveness of educational expenditure. In our view, it remains unlikely that the Reserve Bank's inflation-targeting regime will come under review in the near term, owing to the sensitive market

juncture, despite calls by some left-wing elements to introduce growth or employment considerations in its mandate.

Long-term social needs circumscribe policy

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. Despite advances, this target is now highly unlikely to be met. 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.

Economic Prospects: Growth Slowdown To Deepen

- South Africa is a middle-income country with a well-diversified economy.
- Economic growth will soften in the period to 2011, due both to the cycle and to supply constraints.

Table 2

Republic of South Africa Economic & Financial Indicators								
	2004	2005	2006	2007	2008e	2009f	2010f	2011f
Nominal GDP (bil. ZAR)	1,395.37	1,541.07	1,741.06	1,993.89	2,201.74	2,423.06	2,633.26	2,875.52
Nominal GDP (bil. \$)	216.01	242.33	257.11	283.01	275.22	236.40	277.19	338.30
GDP per capita (\$)	4,544	5,055	5,325	5,777	5,536	4,687	5,416	6,514
Real GDP (% change)	4.9	5.0	5.4	5.1	3.2	1.9	3.5	4.0
Real GDP per capita (% change)	3.9	4.1	4.7	3.6	1.7	0.4	2.0	2.5
Gross domestic investment (% of GDP)	18.6	18.7	21.3	21.5	21.4	21.0	21.2	22.0
Gross domestic savings (% of GDP)	15.4	14.7	14.9	14.2	13.7	13.9	14.9	15.1
Real exports (% change)	2.9	8.0	5.6	8.3	5.0	4.0	5.0	5.0
Consumer price index (% change)	4.3	3.9	4.6	6.5	12.0	8.5	6.7	5.0
Domestic credit to private sector and NFPEs (% change)	14.3	18.0	25.4	22.1	15.0	8.0	10.0	10.0
Domestic credit to private sector and NFPEs (% of GDP)	66.4	70.9	78.7	83.9	87.3	85.7	86.7	87.4

f--Forecast. e--Estimate.

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. Manufacturing accounts for close to 20% of value added, led by petroleum products, chemicals, rubber and plastics, 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 2007, private sector services accounted for about 60% of real growth in value added; construction accounted for another 12%. Finance, real estate, and business services account for about one-half of services growth.

Economic growth

Economic growth was impressive over the past three years, averaging 5.2%. In 2008, we expect it to slow significantly, to 3.2%. This slowdown is due to the sustained monetary policy tightening since mid-2006, the new energy supply constraints that emerged in early 2008, and the global growth slowdown. These factors are only partly offset by robust public investment. 2009 is likely to see another slowdown, to 1.9%, as growth in developed markets evaporates and key commodity prices are hit by the global downturn. Although fiscal policy is expected to loosen somewhat in response to the cycle, the weakening of the rand is likely to prevent monetary policy easing. The short-term risks to growth remain on the downside, owing to pressures on the balance of payments and related currency weakness. In the event of a faster correction of the balance of payments, the slump in domestic demand could be more pronounced than we forecast.

Supply constraints will postpone attempts to boost potential growth for the foreseeable future. The most important infrastructure constraints relate to transport and, most urgently, to power. A low power capacity margin and related blackouts at the beginning of the year contributed significantly to the slowdown in 2008. Sustained investment by power utility ESKOM Holdings Ltd. (BBB+/Watch Neg/--) and a greater focus on managing demand are likely to contain the effects thereafter, but the energy constraint will remain until the early years of the next decade. Nevertheless, other things being equal, the current period of sustained public investment should pave the way for a higher growth trajectory in the medium to long term.

Fiscal Flexibility: Some Space For Countercyclical Policies

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

Table 3

Republic of South Africa Fiscal Indicators								
	2004	2005	2006	2007	2008e	2009f	2010f	2011f
(% of GDP)								
General government revenues	32.5	34.7	35.7	35.9	35.2	34.9	34.6	34.6
General government expenditures	34.1	34.9	34.9	34.8	35.7	36.9	36.6	36.1
General government balance	(1.6)	(0.2)	0.8	1.1	(0.5)	(2.0)	(2.0)	(1.5)
General government primary balance	2.1	3.3	3.9	4.0	2.4	0.6	0.5	1.0
General government balance (% of revenues)	(4.9)	(0.5)	2.2	2.9	(1.4)	(5.7)	(5.8)	(4.3)
General government interest payments (% of revenues)	11.2	9.9	8.8	8.1	8.1	7.6	7.3	7.2
General government debt	36.4	35.3	33.1	28.6	26.4	26.0	25.9	25.3
General government net debt	31.1	28.8	24.3	20.2	18.8	19.1	19.5	19.4

f--Forecast. e--Estimate.

Revenue, expenditure, and balance performance

After running surpluses close to 1% of GDP for the past two fiscal years (ending March 31), we expect the general government to return to deficits in the region of 2% of GDP for the next two, and to remain in deficit in the period to 2011/2012. The ratio of government revenues to GDP will weaken, due to the growth and commodity downturns, as well as a moderation of revenue elasticity from recent highs. More importantly, the fiscal loosening

also reflects the fact that the Treasury's expenditure trajectory has been boosted, largely owing to a South African rand (ZAR) 60 billion loan to assist Eskom's capital expenditures, as well as adjustments to spending programs to accommodate higher inflation. In addition, we expect that the administration sworn in after the Spring 2009 general election will raise expenditure moderately, over and above the Treasury's current medium-term plans, from 2010/2011 onwards. Nevertheless, market discipline in the context of the large external financing requirement will preempt a major fiscal policy departure.

The trend of rebalancing public spending towards capital investment remains, with capital expenditure planned to reach almost 11% of total spending by 2011/2012. Significant spending pressures remain, particularly owing to chronic infrastructure shortages, high poverty levels, and health-related (primarily HIV/AIDS) issues. The 2010 World Cup, which South Africa will host, is also adding to short-term investment pressures.

Government debt and interest

Continued fiscal prudence has contributed to falling general government debt, which will stand at an estimated 26% of GDP at the end of 2008, almost one-half the level of 10 years ago. The interest burden represents about 3% of GDP. Foreign currency debt amounts to less than 15% of total debt, dominated by the euro, the U.S. dollar, and to a lesser extent the yen. The broader public sector (including state-owned enterprises) will have a borrowing requirement in the region of 3% GDP per year from 2009/2010 to 2011/2012 (compared with a requirement of 0.3% in 2007/2008) owing to aggressive investment plans by the nonfinancial public enterprises (NFPEs).

Off-budget and contingent liabilities

Explicit government guarantees amounted to ZAR68 billion in 2006/2007, with Transnet accounting for the largest proportion. This is likely to rise significantly in the near term, however, owing to a guarantee application made by Eskom to help it fund its large medium-term capex program. Standard & Poor's believes that, aside from explicit guarantees, the government's implicit support to, and monitoring of, Eskom will remain strong through the coming years' capital investment period, owing to its central role in removing growth constraints, and the impact of its investments on imports.

We estimate the fiscal cost of a reasonable worst-case banking sector crisis at 18% of GDP. The key risk to the sector arises from recent rapid increases in household leverage, reflected in record levels of household debt in excess of 75% of disposable incomes. Recent years' credit growth has led to some increase in nonperforming loans in the banking sector, but the deterioration in asset quality through the downturn is expected to remain manageable. 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, contributing to dampen credit growth.

Monetary Policy: Rand Correction Complicates The SARB's Task

- The SARB, whose goal is the achievement and maintenance of price stability, has tightened monetary policy amid heightened inflationary pressures.
- The sharp depreciation and continued volatility of the rand will complicate the SARB's policy options in the near term.

Depreciation will delay disinflation

The SARB tightened its repo rate by 500 basis points between June 2006 and June 2008, raising it to 12% in response to increasing inflationary pressures. CPIX (CPI excluding mortgage interest payments) first breached the

3%-6% band targeted by the SARB in April 2007 (reaching 6.3%) and rose steadily thereafter despite the tightening credit conditions. Rising energy and food prices were key contributors, as was recent rapid credit growth.

Exogenous fuel and food pressures are falling away rapidly due to global trends. Meanwhile, private sector credit growth is expected to continue slowing in response to the interest rate rises, softening real estate inflation, and the introduction of the NCA in June 2007. Nevertheless, inflation expectations have recently risen, and very large electricity price hikes are likely to continue in response to ESKOM's investment needs. Finally, the weakening rand will increase imported inflation. As a result, even if it turns out that the rate cycle has peaked, the SARB is unlikely to seek a looser monetary stance for some months, laying the onus of countercyclical policies on the fiscal pillar.

A new CPI index will be introduced in January 2009, including new weights and a measure of rent inflation. This will replace the CPIX as the SARB's target, within the same band of 3%-6%. Although the CPI is expected to be slightly lower than the CPIX in January, the monetary policy stance is unlikely to be adjusted for that reason.

Exchange rate to remain weak and volatile in 2009

The rand tends to be vulnerable to changes in investor sentiment due to its liquidity, its use for proxy emerging market trades, and more recently, political uncertainties and the substantial current account deficit. In the year to December, the rand depreciated by more than 30% against the dollar. South Africa's heightened balance-of-payments exposure, concurrent with further bouts of "flight to liquidity" in the context of global deleveraging, appears likely to prolong the period of currency weakness and volatility until 2010, despite widening interest rate differentials. In the shorter term, the general election in Spring of 2009 could provide a flashpoint for further sharp movements.

Depreciation will not have tangible negative implications for the financial system, but it does further increase the downside risks to growth. The correction will either re-price South African assets to attractive levels, or help to contain the current account deficit by depressing domestic demand and raising export competitiveness, or both. In the current global market environment, the risks are tilted towards a sharper domestic demand adjustment.

External Finances: Out In The Cold

- The balance of payments is hitting external financing constraints.
- The net portfolio equity flows that have hitherto financed the bulk of the imbalance have been under pressure since late 2007, and are unlikely to recover durably in the foreseeable future.
- Total external debt, net of the most liquid assets, remains moderate.

Table 4

Republic of South Africa External Indicators								
	2004	2005	2006	2007	2008e	2009f	2010f	2011f
(% of GDP)								
Current account balance	(3.2)	(4.0)	(6.4)	(7.3)	(7.6)	(7.0)	(6.3)	(6.9)
Net foreign direct investment	(0.3)	2.3	(2.6)	0.9	2.0	1.5	1.5	1.5
(% of CARs)								
Current account balance	(11.4)	(13.6)	(20.1)	(21.4)	(21.9)	(20.9)	(19.1)	(21.1)
Net external liabilities	33.9	47.6	50.1	72.7	89.6	122.6	120.4	114.0
Total external debt	68.7	62.2	65.7	65.2	60.1	70.7	63.5	61.4

Table 4

Republic of South Africa External Indicators (cont.)								
General government external debt	0.2	0.2	0.2	0.2	0.1	0.2	0.2	0.2
Narrow net external debt*	10.6	1.6	2.0	2.0	16.0	27.2	28.5	26.9
Net public sector external debt	10.4	1.0	(3.7)	(14.9)	(13.3)	(10.8)	(4.9)	(2.4)
Net nonbank private sector external debt	(2.9)	(3.2)	2.3	6.9	8.4	15.7	14.9	10.9
Net banking sector external debt	(20.5)	(17.3)	(16.3)	(6.9)	7.5	13.1	12.7	11.5
Net investment payments	7.0	6.9	6.5	9.2	8.8	7.9	6.0	7.7
Net interest payments	2.0	1.4	1.5	1.0	0.4	0.9	1.4	1.5
Reserves/CAPs (months)	1.4	2.2	2.5	2.6	3.4	3.9	3.4	2.7
Gross external financing needs (% of CARs and usable reserves)	118.5	114.0	115.9	117.2	114.7	112.7	110.9	113.1

*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 2007, the trade deficit improved slightly to 2% of GDP, but this was more than offset by a marked deterioration on the income account. The overall current account deficit was 7.3% of GDP, compared with an already high 6.4% in 2006.

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. These payments slightly distort the interpretation of the current account as they do not imply a need for foreign financing. Instead, the payments are made in rand and are likely to remain in rand because of significant exchange rate management against the rand in the recipient countries, and their high levels of trade with South Africa.

Looking ahead, our base case is that investment-related imports and dropping foreign demand for exports will prevent the trade deficit from improving significantly. In addition, depreciation will at least partly offset reduced prices for key imports. On the export side, the commodity downturn will affect platinum group prices and volumes, while gold will be somewhat shielded by its safe haven status but appears unlikely to gain significantly.

Despite occasional large transactions, net FDI generally contributes little to external financing. This is because of 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 in foreign exchange.

Portfolio inflows traditionally fund the deficit, particularly those into the Johannesburg Stock Exchange (JSE). However, these inflows are by nature unpredictable. The global financial turmoil has led to at times sharply negative net foreign purchases of South African equities and bonds since the beginning of 2008. In the short term, there could be further sharp portfolio outflows if the flight to liquidity in developed market continues. In time, the weaker rand should re-price South African assets to attractive levels. But in the absence of sufficient financial account balances to fund the current account deficit, the adjustment might instead occur through a sharper correction in domestic absorption and related imports.

Narrow net external debt

External debt has fallen over recent years, which is particularly important given South Africa's external liquidity exposure. The government's funding strategy remains concentrated in the domestic market. A net decrease in recourse to foreign financing will be offset by the valuation effect of the rand's depreciation against the major currencies. The effects of depreciation are partly mitigated by the fact that about 15%-20% of government external debt (as recorded by the international investment position prior to the recent sell-off) is rand-denominated debt held by non-residents.

Narrow net external debt is expected to rise to 16% of CARs in 2008, and to climb to 27% in the period to 2011. A portion of South Africa's investment plans will be financed by foreign debt (including export credit agency and multilateral lending institution debt), contributing to the increase; if public corporations remain unable to borrow abroad for some time, the government could step in with guarantees or direct onlending. The banking sector is expected to have turned into a net external debtor to the tune of 8% of CARs in 2008, in part due to a run-down of its external assets in response to the country's external payments imbalance. This net external debt position is expected to deteriorate more gradually in 2009-2011, to 11% of CARs at the end of the period. The nonbank private sector is likely to face external funding difficulties in the short term. We forecast broadly flat external borrowing by this sector over the next two years (net of redemptions), but some rundown of its external assets also appears likely, leading to a net external debt position of 11% of CARs by 2011. These net external debt ratios remain moderate in international comparison, South Africa's main external vulnerability being on the liquidity side.

Aarti Sakhuja provided research assistance for this report.

Ratings Detail (As Of December 11, 2008)*

South Africa (Republic of)

Sovereign Credit Rating

Foreign Currency

BBB+/Negative/A-2

Local Currency

A+/Negative/A-1

South African National Scale

zaAAA/--/zaA-1

Senior Unsecured (39 Issues)

A+

Senior Unsecured (11 Issues)

BBB+

Short-Term Debt (1 Issue)

A-2

Sovereign Credit Ratings History

11-Nov-2008

Foreign Currency

BBB+/Negative/A-2

01-Aug-2005

BBB+/Stable/A-2

07-May-2003

BBB/Stable/A-3

11-Nov-2008

Local Currency

A+/Negative/A-1

01-Aug-2005

A+/Stable/A-1

07-May-2003

A/Stable/A-1

29-Mar-2006

South African National Scale

zaAAA/--/zaA-1

*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.

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