

South Africa (Republic of)

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Table Of Contents

Major Rating Factors

Rationale

Outlook

Comparative Analysis

Political Environment: Key Questions Are In The Medium Term

Economic Prospects: First Signs Of A Turnaround

Fiscal Flexibility: Space For A Concerted Borrowing Push

Monetary Policy: Widening Output Gap Prompts Rate Cuts

External Finances: Touch-And-Go Financing

South Africa (Republic of)

Major Rating Factors

Strengths:

- Prudent macroeconomic policies and a moderate, though rising, 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, putting pressure on policy.
- 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 rating reflects South Africa's prudent macroeconomic policies, a moderate (albeit rising) debt burden, and stable political institutions. These are balanced by the country's continued high reliance on external portfolio inflows in the context of a significant current account deficit, and severe structural socioeconomic weaknesses.

Against the background of economic recession, a large revenue shortfall has formed during 2009, which we anticipate will be the main factor leading to a much higher than expected 8% of GDP deficit in fiscal 2009/2010 (ending in March), compared with an initial budget of 4%. In view of the downturn, the Treasury is letting automatic stabilizers take effect on the revenue side. In parallel, the wider public sector is frontloading investment spending to counter the cycle, partly with government guarantees, leading to a likely public sector borrowing requirement of 12% of GDP in 2009/2010. Meanwhile, the central bank has cut the repo rate by 500 basis points since December 2008, to 7%.

The past few years' declining debt trend has ended, and the ratio of debt-to-GDP will rise steadily over the period to 2012/2013, to an expected 41% of GDP. Assuming the government follows its planned consolidation path, the burden should stabilize below 50% of GDP, but this will require significant expenditure restraint relative to the past few years. The higher public sector debt supply should eventually lead to a steepening of domestic yields, which would increase the cost of debt. Strong pent-up demand for South Africa's international issues could offer an outlet in the event of crowding-out on the domestic market. The Treasury, however, has hitherto capped its foreign borrowing owing to currency risk.

In line with our expectation of a 1.7% GDP contraction, we anticipate a tangible but temporary reduction in the current account deficit in 2009, to 4.9% of GDP from 7.6% in 2008. The global financial turmoil has driven higher exchange rate volatility and several waves of pressure on the South African rand, followed by strong re-appreciation since the first quarter of 2009. Net portfolio inflows have surprised on the upside during 2009, in line with the wider recovery in emerging market sentiment. Nevertheless, the balance of payments remains exposed to volatile financing.

Our base case remains a broad continuation under President Jacob Zuma of the past few years' prudent macroeconomic stance. In particular, we anticipate that the Treasury will retain the main role in macroeconomic policy. Nevertheless, the greater diversity of economic views in policy circles, while a positive for political openness, could complicate efforts to bring the fiscal deficits down in the medium term.

Outlook

The negative outlook reflects our view of downside macroeconomic risks to our base case, combined with political uncertainty surrounding the prospects for fiscal consolidation once growth recovers. Continued responsiveness to the risks associated with volatile balance-of-payments financing, combined with a credible commitment to a reversal of the rising public debt trend once revenues rebound, would support the ratings. Downward pressure on the ratings could mount during 2010 if we were to observe signs that the authorities' commitment to prudent macroeconomic management was weakening, or insufficient to reverse the rising trend of the government debt ratio over the medium term.

Table 1

Republic of South Africa Selected Indicators										Median BBB (2010e)
	2004	2005	2006	2007	2008	2009	2010e	2011f	2012f	
GDP per capita (\$)	2,268	2,428	2,445	2,564	2,424	2,345	2,561	2,744	2,990	9,783
Real GDP (% change)	4.9	5.0	5.3	5.1	3.1	(1.7)	2.0	3.5	3.5	3.0
Real GDP per capita (% change)	0.0	0.0	(0.1)	0.1	0.0	(2.4)	1.3	2.8	2.8	2.0
General government balance (% of GDP)	(1.6)	(0.2)	0.8	1.1	(1.5)	(7.8)	(6.0)	(5.0)	(4.0)	(3.5)
General government debt (% of GDP)	35.9	34.2	31.7	28.9	29.7	35.7	39.1	40.6	41.0	39.1
Net general government debt (% of GDP)	30.6	27.7	23.0	20.5	19.4	26.1	30.1	32.5	33.6	34.5
General government interest exp. (% of revenues)	11.2	9.9	8.7	7.7	6.9	9.3	10.5	11.4	11.8	8.9
Domestic credit to private sector & NFPEs* (% of GDP)	66.3	70.7	78.5	83.6	80.7	78.3	78.2	78.4	78.6	68.5
Consumer price index (average; % change)	1.4	3.4	4.6	7.2	11.5	7.5	6.0	6.0	6.0	4.0
Gross ext. financing needs¶ (% of CARs and usable reserves)	118.5	114.0	115.5	117.3	113.4	109.4	113.4	113.2	113.3	113.9
Current account balance (% of GDP)	(3.2)	(4.0)	(6.3)	(7.3)	(7.6)	(4.9)	(5.9)	(6.1)	(6.3)	(2.2)
Narrow net external debt§ (% of CARs)	10.6	1.6	2.0	2.1	3.0	5.1	6.1	5.9	7.2	27.8

*Standard & Poor's estimates that, in a reasonable worst-case economic downturn, gross problematic assets could reach 10%-20% of domestic credit to the private sector and NFPEs; see "Banking Industry Country Risk Assessments", published monthly on RatingsDirect. ¶Gross external financing needs are defined as current account outflows plus short-term debt by remaining maturity. §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. NFPEs--Nonfinancial public sector 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.
- The fiscal stance is responsive to current macroeconomic risks, which compares favorably with all peers. Government debt is still moderate, although it is undergoing a steep countercyclical rise.

South Africa's closest peers include other sovereigns with significant social and developmental pressures, such as the Republic of India (BBB-/Negative/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+/Negative/A-2), The Russian Federation (BBB/Stable/A-3), the Republic of Hungary (BBB-/Stable/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 that is characteristic in China under the Communist Party, and in Russia under President Dmitry Medvedev and Prime Minister Vladimir Putin.

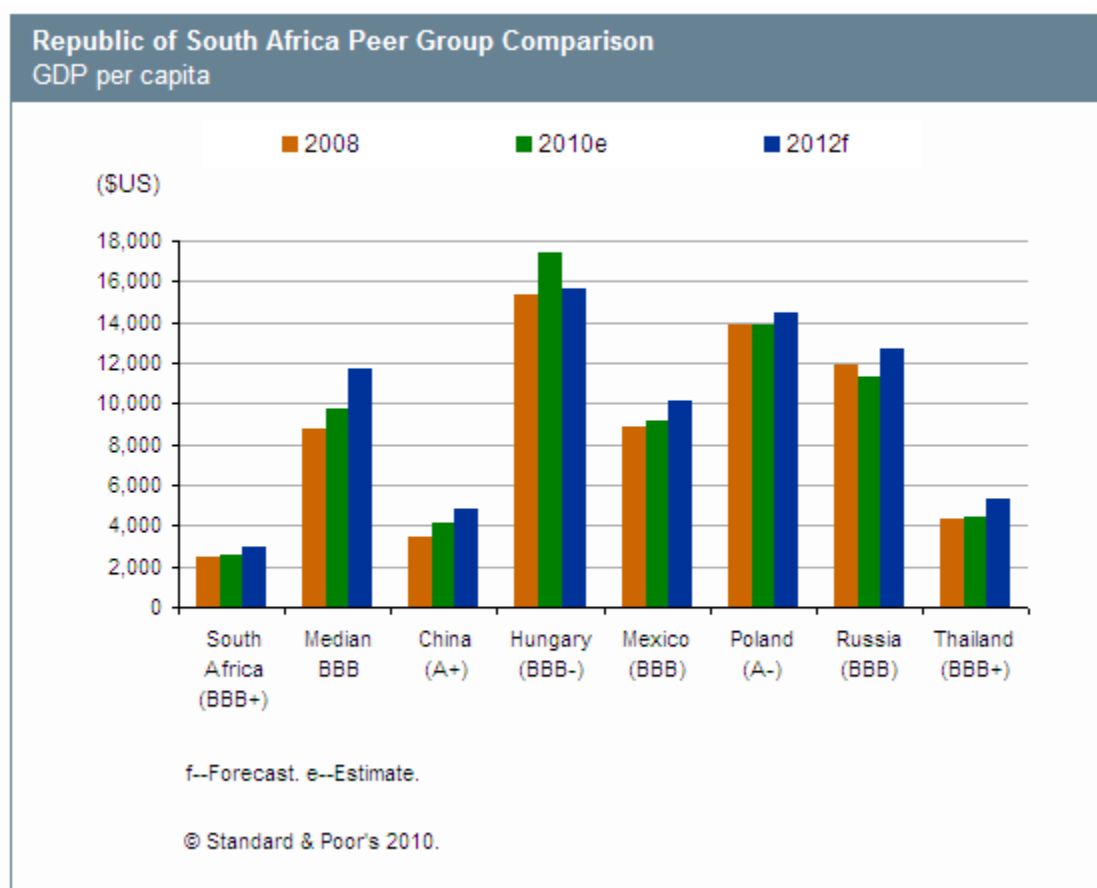
South Africa has been successful in treading a fine line between macroeconomic prudence and the need for rapid socioeconomic improvements. Our baseline scenario is that this will remain the case under President Jacob Zuma. China presents some parallels, although policies there have encouraged faster 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 arguably been marked by reduced policy predictability, particularly in Hungary.

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 does not stand out within the peer group (see chart 1). Health and education issues, however, are reflected in South Africa's very low ranking of 125 out of 179 countries in the United Nations Development Program (UNDP) Human Development Index. The challenges are comparable to those facing India (132), but more substantial than for other peers such as China (94), Thailand (81), and Mexico (51). Poland (39) and Hungary (38) are the best-performing peers.

Chart 1



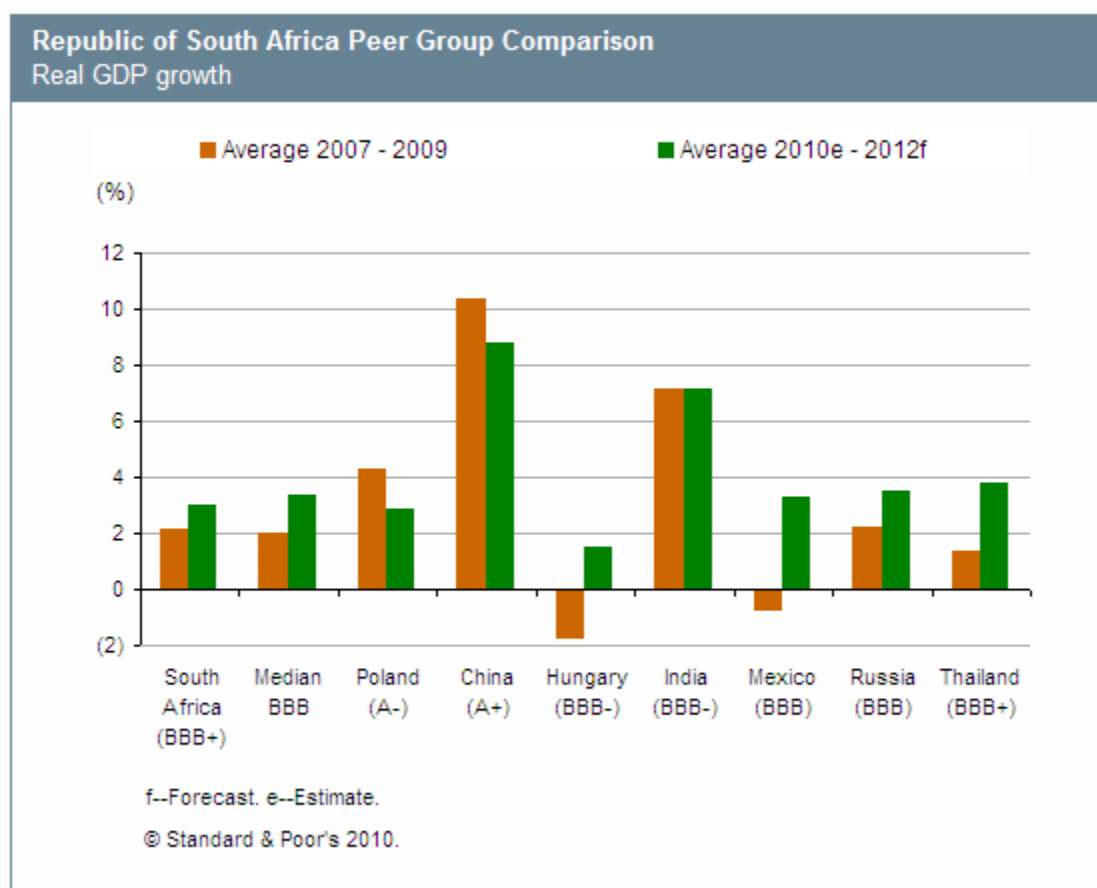
South Africa's Gini coefficient of income inequality is the worst of the peer group, at 58, according to 2007 World Development Indicators. Other poor performers include China (47) and Mexico (46). By contrast, Hungary (27) and Poland (35) score best among the peers.

These developmental challenges faced by South Africa weigh on its creditworthiness, giving rise to long-term expenditure needs and 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

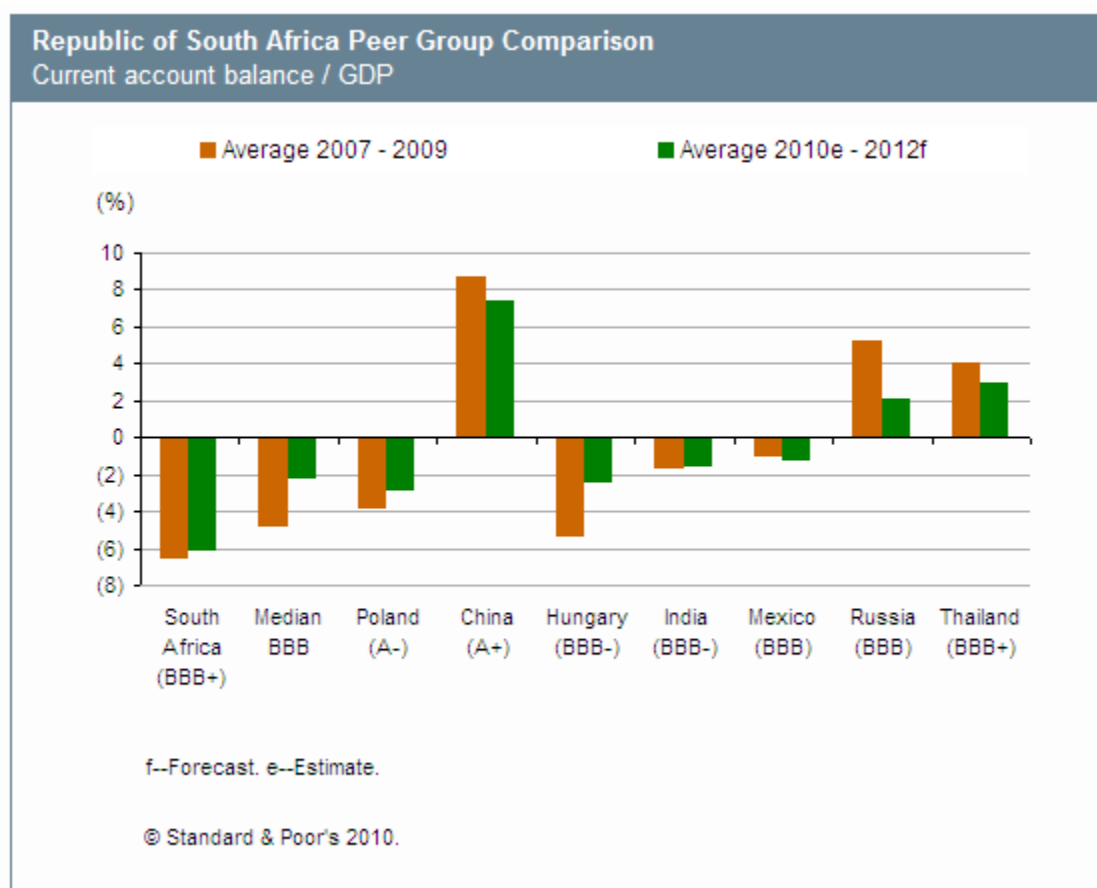
The South African economy is well diversified, similar to that of all peers apart from Russia, which is heavily reliant on hydrocarbons, and Mexico, where growth is highly correlated to U.S. economic expansion. Nevertheless, skills mismatches, microeconomic constraints, and low levels of investment have held back the pace of growth. 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' median. Public investments are also being frontloaded to counter the economic cycle, which has contributed to a comparatively shallow recession in 2009 given the international context (see chart 2).

Chart 2



A deterioration in the trade balance, combined with a structural deficit in invisibles, pushed the current account deficit above 7% of GDP in 2008. Driven by last year's GDP contraction, there was a tangible reduction in South Africa's current account deficit in 2009, but we believe the public sector investment push will keep it relatively high for the foreseeable future, at an average of 6% of GDP during 2010-2012. This compares unfavorably with the 'BBB' median and all peers (see chart 3).

Chart 3



External funding mix is a source of vulnerability

South Africa posts generally small and erratic foreign direct investment (FDI) coverage of its current account deficit, relying instead on large portfolio equity inflows, which contrasts with all peers. Portfolio flows swung to negative territory in 2008, although there was still an overall surplus in the balance of payments thanks to other inflows. Since the second quarter of 2009, the inflows have recovered strongly, but the background vulnerability of the balance of payments remains. South Africa's exceptionally liquid equity and debt markets by emerging market standards render the country's external flows vulnerable to the ebbs and flows of investor sentiment towards the emerging market asset class in general. 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.

The impact of balance-of-payments adjustments is dampened by the rand's free-floating exchange rate, although sustained depreciations and appreciations in turn can complicate the task of monetary policy and act as an investment disincentive. Moreover, in the event of new shocks to global investor confidence, depreciation may not always re-price South African assets to a sufficiently attractive level to fully restore the financial account surplus. As a result, external financing constraints can weigh on domestic demand instead.

Space for countercyclical fiscal policies

South Africa, China, Mexico, Thailand, and Russia post general government debt levels below 40% of GDP. South Africa, however, has also built up borrowing requirements among its public enterprises, as part of a concerted

countercyclical push underpinned by pre-existing investment projects. The fiscal prudence of the past few years ensured moderate deficits or small surpluses, which we believe provides sufficient balance sheet space for this stimulus, as long as it is reversed in the medium term (see chart 4). This contrasts most clearly with India and Hungary, whose fiscal flexibility is constrained by comparatively large net general government debt burdens (see chart 5).

Chart 4

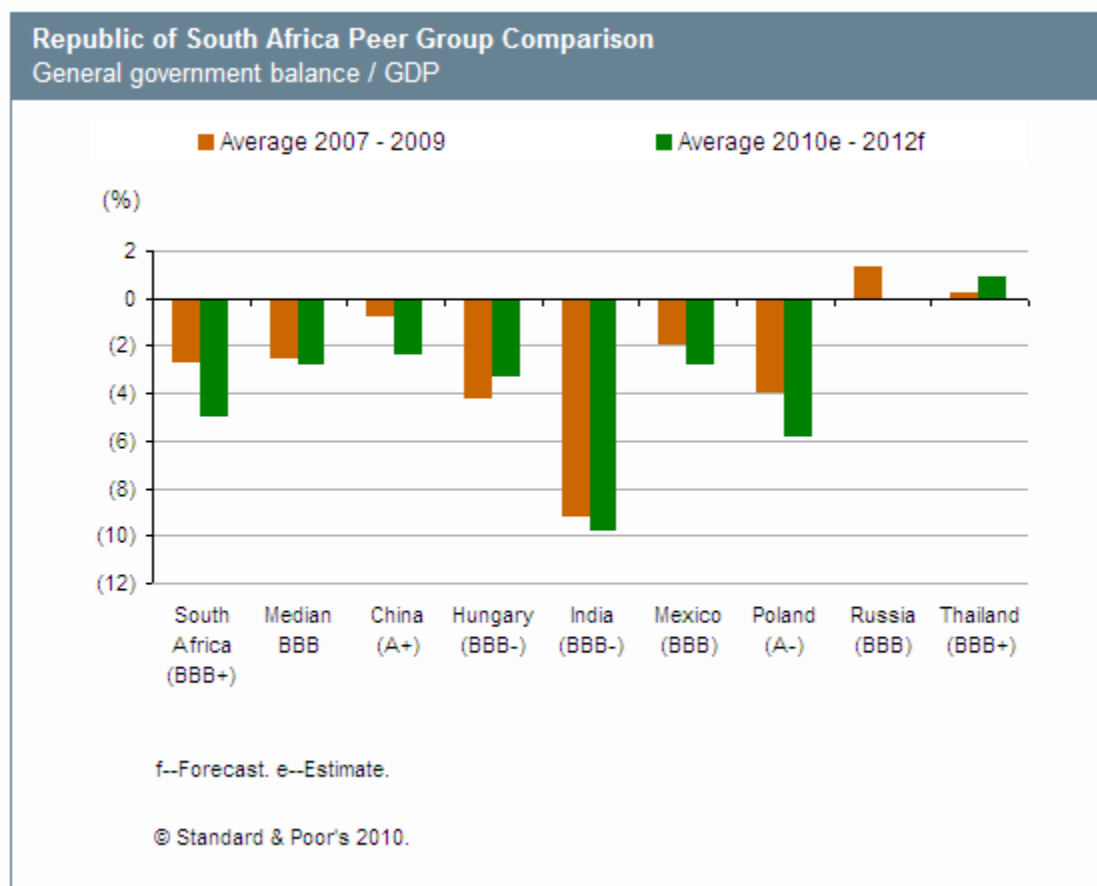
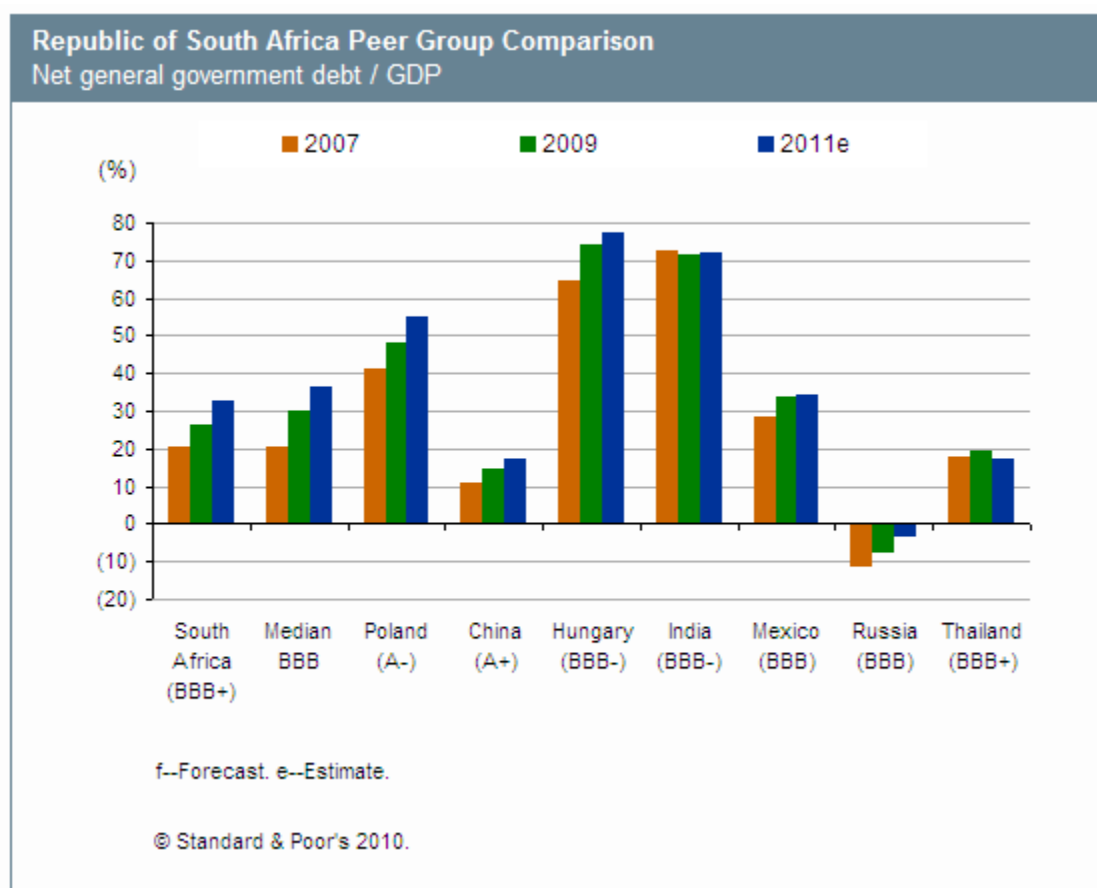


Chart 5



Notwithstanding the current cyclical deterioration, South Africa's fiscal flexibility is on an improving trend, on the back of a broadening revenue base. In this respect, it compares well with Russia and Mexico, which rely 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 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 16% of GDP for South Africa, which compares well with the peer group.

Political Environment: Key Questions Are In The Medium Term

- Jacob Zuma became president in May 2009. Key cabinet and central bank appointments have underpinned macroeconomic policy continuity.
- Despite an intensification of debates, 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. The latter won just under two-thirds of the vote in the April 2009 general election, paving the way for the inauguration of its new leader Jacob Zuma as president the following month.

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. Moreover, the ANC's democratic credentials were strengthened by its hotly contested leadership election in 2007, introducing greater competition and accountability in party processes. Following former President Thabo Mbeki's resignation in September 2008, a number of ANC figures not from Mr. Zuma's camp left the ANC to form a new party, named Congress of the People (COPE), which could also lead to greater political competition in due course.

More debate, but a 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 social pressures. Our base case remains a broad continuation of the prudent macroeconomic policies of the previous administration:

- Any major deviation from the current macroeconomic framework is circumscribed by the economy's exposure to market sanction.
- The countercyclical fiscal and monetary stances adopted since late 2008 have reduced the force of calls for more expansionary policies.
- The ANC camp that unseated Mr. Mbeki was united by its opposition to the former president, and is less likely to unite behind radical policy shifts, particularly owing to the presence of high-profile business executives on the ANC National Executive Committee, and the growing links between business and politics in South Africa over recent years.

Former finance minister Trevor Manuel was appointed to head a new National Planning Commission within the presidency, while the former head of the South African Revenue Service Pravin Gordhan was named to replace him. A new Ministry of Economic Development was created, headed by left-wing figure Ebrahim Patel, raising concerns that the Treasury could lose some control over economic policy. The balance and modus operandi between the National Planning Commission and the economic ministries will take some time to emerge. We anticipate that the Treasury will retain the main role in macroeconomic policy. Nevertheless, the greater diversity of economic views in policy circles could complicate efforts to bring the fiscal deficits down in the medium term.

Long-term social needs circumscribe policy

Inequality, notwithstanding the rapid growth of the black middle class, remains strongly linked to racial differences. The government's Black Economic Empowerment (BEE) initiative has come under increasing criticism for failing to spread new-found black wealth, and is likely to come under revision. However, skills shortages among the wider black population make the practical implementation of BEE policies challenging. Similarly, land reform has hitherto proceeded slowly and unevenly.

Economic Prospects: First Signs Of A Turnaround

- South Africa is a middle-income country with a well-diversified economy.
- The global downturn led to South Africa's first recession in 17 years and a rapid unemployment increase.
- The recovery is likely to be gradual and supported by robust public sector investment.

Table 2

Republic of South Africa Economic & Financial Indicators									
	2004	2005	2006	2007	2008	2009	2010e	2011f	2012f
Nominal GDP (bil. ZAR)	1,395	1,544	1,745	1,999	2,284	2,425	2,621	2,876	3,155
Nominal GDP (bil. \$)	216	243	258	284	276	269	296	320	351
GDP per capita (\$)	2,268	2,428	2,445	2,564	2,424	2,345	2,561	2,744	2,990
Real GDP (% change)	4.9	5.0	5.3	5.1	3.1	(1.7)	2.0	3.5	3.5
Real GDP per capita (% change)	0.0	0.0	(0.1)	0.1	0.0	(2.4)	1.3	2.8	2.8
Real domestic demand (% change)	7.7	5.4	7.8	4.9	3.1	(3.3)	2.2	3.8	3.9
Real investment (% change)	8.9	10.2	13.2	16.3	10.2	2.5	4.5	7.0	7.0
Gross domestic investment (% of GDP)	18.6	18.7	21.2	21.9	22.1	23.4	23.6	23.9	24.3
Gross domestic savings (% of GDP)	15.4	14.7	14.9	14.6	14.5	18.6	17.6	17.9	18.0
Real exports (% change)	2.9	8.0	6.0	7.5	1.7	(19.8)	3.8	5.0	5.0
Unemployment rate (average claimant count; %)	105.2	100.0	109.5	111.3	109.5	23.5	23.0	22.0	22.0
Real GDP per employee growth (%)	6.2	0.0	2.3	5.1	0.2	(6.4)	(2.7)	(1.5)	(1.3)
Consumer price index (% change)	1.4	3.4	4.6	7.2	11.5	7.5	6.0	6.0	6.0
Domestic credit to private sector & NFPEs (% change)	14.3	18.0	25.4	22.1	10.2	3.0	8.0	10.0	10.0
Domestic credit to private sector & NFPEs (% of GDP)	66.3	70.7	78.5	83.6	80.7	78.3	78.2	78.4	78.6

f--Forecast. e--Estimate. NFPEs--Nonfinancial public sector enterprises.

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 have been a key growth driver in recent years. Within services, finance, real estate, and business services have expanded most rapidly, but were also hit hard by the global downturn. In the short term, large public investments and construction should drive South Africa's exit from recession and support the recovery.

Economic growth

Following a decade of sustained expansion, real GDP growth slowed to 3.1% in 2008, and should contract by 1.7% in 2009. The world recession coincided with the end of a debt-fuelled consumption boom, the effects of a sustained monetary policy tightening since mid-2006, and the emergence of energy supply constraints since early 2008. Both fiscal and monetary policies have loosened significantly in response to the cycle, and will remain conducive for the recovery over the medium term, allowing domestic demand to gradually pick up again. In addition, large public investments in infrastructure, combined with the recovery in global demand, lower inflation, and more favorable commodity prices, should help to pave the way for a higher growth trajectory. We anticipate real GDP to grow by

2% in 2010 and 3.5% in 2011.

Background supply constraints on potential growth remain. The most important infrastructure bottlenecks relate to transport and power. Although the recession has eased pressure on power capacity, and sustained investment by state-owned power utility ESKOM Holdings Ltd. (foreign currency BBB+/Watch Neg/--) is likely to contain the effects thereafter, we believe energy constraints will remain until the early years of the next decade.

Fiscal Flexibility: Space For A Concerted Borrowing Push

- The government is using some of the fiscal space it created in the past few years to lean against the cycle.
- General government debt is expected to remain broadly stable in the medium term.
- Off-budget and contingent liabilities are manageable.

Table 3

Republic of South Africa Fiscal Indicators									
	2004	2005	2006	2007	2008	2009	2010e	2011f	2012f
(% of GDP)									
General government revenues	32.5	34.6	35.6	35.9	34.8	33.2	32.9	32.9	32.9
Of which central government	25.8	27.9	29.0	29.6	28.0	27.0	26.8	26.8	26.8
General government expenditures	34.1	34.8	34.8	34.8	36.3	41.0	38.9	37.9	36.9
Of which central government	27.2	28.1	28.2	28.3	28.7	34.8	32.8	31.8	30.8
General government balance	(1.6)	(0.2)	0.8	1.1	(1.5)	(7.8)	(6.0)	(5.0)	(4.0)
Of which central government	(1.4)	(0.1)	0.8	1.3	(0.7)	(7.8)	(6.0)	(5.0)	(4.0)
Of which local authorities	(0.4)	(0.5)	(0.4)	(0.6)	(0.6)	(0.4)	(0.4)	(0.4)	(0.4)
General government primary balance	2.0	3.2	3.9	3.8	0.9	(4.7)	(2.5)	(1.3)	(0.1)
Central government primary balance	2.1	3.2	3.8	3.9	1.6	(4.9)	(2.2)	(0.9)	0.3
General government balance (% of revenues)	(4.9)	(0.5)	2.2	3.0	(4.3)	(23.5)	(18.2)	(15.2)	(12.2)
General gov't interest payments (% of revenues)	11.2	9.9	8.7	7.7	6.9	9.3	10.5	11.4	11.8
Central gov't interest payments (% of revenues)	13.6	11.8	10.3	8.9	8.3	10.5	13.9	15.1	15.8
General government debt	35.9	34.2	31.7	28.9	29.7	35.7	39.1	40.6	41.0
Of which central government debt	35.9	34.2	31.7	28.9	27.5	33.6	37.0	38.7	39.2
General government net debt	30.6	27.7	23.0	20.5	19.4	26.1	30.1	32.5	33.6
Of which central government net debt	30.6	27.7	23.0	20.5	17.2	23.9	28.1	30.6	31.8

f--Forecast. e--Estimate.

Revenue, expenditure, and balance performance

After running surpluses close to 1% of GDP in fiscal 2006/2007 and 2007/2008 (ending March 31), the general government returned to a small deficit in 2008/2009. Against the background of economic recession, a large revenue shortfall has formed during 2009, which will be the main factor leading to a much higher than expected 8% of GDP deficit in 2009/2010, compared with an initial budget of 4%. In view of the downturn, the Treasury is letting automatic stabilizers take effect on the revenue side. The fiscal loosening also reflects the fact that the Treasury's expenditure trajectory was boosted on the occasion of the October 2008 Medium-Term Budget Policy Statement, largely owing to a South African rand (ZAR) 60 billion (2.3% of estimated 2010 GDP) loan to assist Eskom's capital expenditures, as well as adjustments to spending programs to accommodate higher inflation.

In the medium term, the Treasury foresees an only gradual reduction of the deficit. On the revenue side, actual performance could surprise on the upside owing to conservative growth assumptions. On the expenditure side, however, the fiscal plan foresees a sharp deceleration in real spending growth, to an average of 1% over the next three fiscal years after an average of 9% over the past three. This is a challenging goal, although it may be aided by a renewed push for public sector efficiencies, a focus on improved service delivery over increased departmental budgets, and lower wage growth following a large increase in 2009/2010. Returning to lower deficits may also be complicated by shifts in political forces under President Zuma.

The wider public sector has increased spending significantly, combined with a coordinated push by state-owned Development Finance Institutions (DFIs) to lend for capital expenditure purposes. Much of this spending is part of the public sector's long-term infrastructure development plan, but is being frontloaded in a countercyclical manner. As a result, the public sector borrowing requirement (including public enterprises) has risen from 3.8% of GDP in 2008/2009 to 11.8% in 2009/2010 and an average of 9.7% over the next three fiscal years. In the long term, significant further spending pressures will remain, due not only to infrastructure shortages, but also to high poverty levels and health-related (primarily HIV/AIDS) issues.

Government debt and interest

Prior to 2008, continued fiscal prudence had contributed to a falling general government debt burden. This trend has ended, and the ratio of debt to GDP will rise sharply over the period to 2012/2013, to 41% of GDP. Assuming the government follows its planned consolidation path, the burden will stabilize below 50% of GDP, but only beyond the forecast period. The interest burden is moderate at 7% of revenues in 2008/2009, although it is likely to rise somewhat as higher public sector supply should eventually lead to a steepening of domestic yields. Foreign currency debt amounts to about 12% of total debt. Strong pent-up demand for South Africa's international issues could offer an outlet in the event of crowding-out on the domestic market. The Treasury, however, has hitherto capped its foreign borrowing owing to currency risk.

Off-budget and contingent liabilities

Explicit government guarantees amounted to ZAR64 billion (2.8% of 2008 GDP) in 2007/2008, with public entities accounting for the bulk. This is rising significantly, however, as the government in February 2009 granted Eskom ZAR176 billion (7.2% of 2009 GDP) in guarantees over five years to support its capital expansion 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. New guarantees to other public entities are also possible over the next few years, depending on borrowing conditions.

We estimate the fiscal cost of a reasonable worst-case banking sector crisis at 16% of GDP. The key risk to the sector arises from recent years' rapid increases in household leverage, reflected in record levels of household debt. Nonperforming loans are increasing, consistent with the downturn, but the deterioration in asset quality is expected to remain manageable through the cycle.

Monetary Policy: Widening Output Gap Prompts Rate Cuts

- The South African Reserve Bank's (SARB), whose goal is the achievement and maintenance of price stability, has loosened monetary policy dramatically since December 2008.
- The volatility of the rand and its bouts of sharp depreciation do not appear to have had a large pass-through

effect. The currency has appreciated again significantly since the first quarter of 2009.

- South African banks are somewhat easing loan conditions, but credit demand is weak.

SARB goes into reverse

Rising energy and food prices, as well as rapid credit growth, prompted 500 basis points of rate hikes by the SARB between June 2006 and June 2008, as well as the introduction of a National Credit Act in 2007 to strengthen lending decisions. In the last quarter of 2008, the collapse in oil prices and rapidly deteriorating global outlook, combined with a pre-existing domestic credit slowdown, led to a reversal of the rate cycle. Since December 2008, the SARB has cut rates by 500 basis points in five steps, as concerns over inflation expectations and regulated price hikes were outweighed by gathering signs of South Africa's growth deterioration and widening output gap, and a very sharp slowdown in domestic credit since the beginning of 2009.

Given the magnitude of the combined stimulus from fiscal and monetary policies since the last quarter of 2008, the central bank appears likely to pause in its monetary loosening. In the context of the economic slump, the main upside risks to inflation stem from regulated prices, owing to Eskom's investment funding needs.

Rand rides on improving emerging market sentiment

The rand is vulnerable to changes in investor sentiment, due to its liquidity and its use for proxy emerging market trades. In 2008, the rand depreciated by 39% against the dollar, fluctuating by 72% from peak to trough. This decline has reversed since the emerging market rally began in March 2009, buoyed by recovering net portfolio inflows despite the April general election. Nevertheless, South Africa's balance-of-payments exposure remains. In the event of new bouts of "flight to liquidity" or emerging market aversion, this could prolong the period of currency volatility and/or prompt renewed depreciation. The SARB does not intervene to defend any particular exchange rate level, but it is active in the market to build reserves, depending on market conditions.

Depreciation risks do not have tangible negative implications for the financial system, but they do further increase the downside risks to growth. If balance-of-payments financing once again comes under pressure, the resulting currency correction will either help to re-price South African assets until capital inflows recover, or help to contain the current account deficit by depressing domestic demand and raising export competitiveness, or both.

SARB mandate debate continues

There have been debates within the ruling ANC-led alliance about possible revisions to the SARB's monetary policy mandate. Options discussed included amending the policy target to comprise both inflation and employment. The flexible exchange rate and inflation-targeting regime are cornerstones of South Africa's current macroeconomic framework. Any major changes that we see as having a practical bearing on the SARB's role, and/or on its credibility in managing expectations, could be relevant to the sovereign credit rating, and would therefore be assessed. Nevertheless, the SARB's loosening cycle since December greatly reduces the likelihood of fundamental changes to its mandate being implemented.

External Finances: Touch-And-Go Financing

- Net portfolio flows have improved in the year to date, but the balance of payments remains dependent on volatile financing, exposing the economy both to the vagaries of global risk appetite and to rapid market sanction in the event of policy slippage.
- Total external debt, net of the most liquid assets, remains moderate.

Table 4

Republic of South Africa External Indicators									
	2004	2005	2006	2007	2008	2009	2010e	2011f	2012f
(% of GDP)									
Current account balance	(3.2)	(4.0)	(6.3)	(7.3)	(7.6)	(4.9)	(5.9)	(6.1)	(6.3)
Trade balance	(0.1)	(0.4)	(2.3)	(2.0)	(1.6)	(0.4)	(0.6)	(0.8)	(1.2)
Net foreign direct investment	(0.3)	2.3	(2.4)	1.0	4.3	1.2	1.5	2.5	2.5
(% of CARs)									
Current account balance	(11.4)	(13.6)	(19.5)	(21.5)	(20.0)	(15.6)	(19.2)	(19.5)	(20.4)
Net external liabilities	33.9	47.6	49.8	70.8	10.2	23.5	35.9	47.6	59.4
Gross external debt	68.7	62.2	65.3	67.9	60.2	80.0	76.6	73.6	70.8
General government external debt	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Narrow net external debt*	10.6	1.6	2.0	2.1	3.0	5.1	6.1	5.9	7.2
Net nonfinancial private sector external debt	(2.9)	(3.1)	2.3	5.7	5.4	4.8	3.3	6.0	7.4
Net financial sector external debt	(20.5)	(17.3)	(16.2)	(9.8)	(2.6)	(0.6)	(1.3)	(3.3)	(2.4)
Net investment payments	7.0	6.9	6.3	9.4	8.7	9.2	10.4	9.8	9.4
Net interest payments	2.0	1.4	1.4	1.0	2.0	2.9	3.7	3.1	2.4
Reserves/CAPs (months)	1.4	2.2	2.5	2.6	3.1	4.2	4.0	3.8	3.7
Gross ext. financing needs¶ (% of CARs and usable reserves)	118.5	114.0	115.5	117.3	113.4	109.4	113.4	113.2	113.3

*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. ¶Gross external financing needs are defined as current account outflows plus short-term debt by remaining maturity. f--Forecast. e--Estimate. CARs--Current account receipts. CAPs--Current account payments.

External liquidity

Declining domestic expenditure and rising savings have helped alleviate the pressure on the current account, which is estimated to have narrowed to a deficit of 4.9% of GDP in 2009, from 7.6% in 2008. The trade deficit shrank as imports contracted more sharply than exports, due to weak demand and rising terms of trade. The income balance also improved somewhat as payments to the rest of the world--mostly generated by large outflows of dividends--declined along with decreasing profits. The deficit on the transfers account, which mostly results from South Africa's payments to members of the Southern African Customs Union, also declined sharply.

We believe the improvement in the current account is likely to be temporary since the recovery will push up import demand, and because foreign holdings of South African assets have been recovering and profit growth will return. In addition, although prices for key South African exports have generally benefited from global conditions in 2009, external demand volumes should recover only gradually, while investment-related imports will weigh on the trade balance.

Despite occasional large transactions, net FDI traditionally contributes little to external financing. This is because of significant FDI-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 strategic foreign investors.

Portfolio inflows traditionally fund the deficit, particularly those into the Johannesburg Stock Exchange. However, these inflows are by nature more volatile and more quickly reversible than FDI flows. 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. Net inflows, and the rand's exchange rate against major currencies, strengthened with the improvement in emerging market sentiment after the first two months of 2009. Nevertheless, volatile external financing continues to expose South Africa to rapid market sanction in the event of domestic developments negatively affecting foreign investor perceptions, as well as during episodes of flight from emerging markets.

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, although increased foreign issuance could become more likely as public financing needs rise and global market conditions improve, particularly if significant pressure on domestic yields emerges.

We anticipate that narrow net external debt will remain in the single digits as a ratio of CARs in the period to 2012. A portion of South Africa's investment plans will be financed by foreign debt (including export credit agency and multilateral lending institution loans to state-owned enterprises), contributing to a moderate increase. There is upside risk to this forecast, if crowding-out risk on the domestic market leads the government to borrow more abroad. The banking sector's net external creditor position fell significantly in 2008, in part due to a run-down of its external assets in response to the country's external payments imbalance, but we anticipate a stabilization of the ratio in 2009. We forecast broadly flat external borrowing by the nonfinancial private sector over the next few years. Net external debt ratios remain moderate by international comparison, and we believe South Africa's main external vulnerability is on the liquidity side.

Priyanka Dixit provided research assistance for this report.

Ratings Detail (As Of January 18, 2010)*		
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 (40 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
Default History		
Default on foreign currency bank debt: 1985-1987, 1989, and 1993.		
Population		49 million
Per Capita GDP		\$2,561 (2010 estimate)

Ratings Detail (As Of January 18, 2010)*(cont.)

Current Government

President Jacob Zuma heads a majority African National Congress (ANC) government.

Election Schedule

National legislative elections:

Last...May 2009

Next...2014

*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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