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SA Economics

# Rand Note

Monday 29 July 2019

Rand runs back through R14.00/USD as South Africa is seen to move closer to becoming a sub investment grade country, as rated by all three of the key credit rating agencies - the probability of the lite down case increases

- After reaching R13.86/USD, R15.62/EUR and R17.40/GBP last week, the rand has run back above R14.00/USD, and closer to R16.00/EUR and R18.00/GBP, as Finance Minister Mboweni proposed further support for Eskom. Fears have arisen of further tax hikes in an environment where growth has dropped towards zero in a decade of rising direct and indirect taxation.

- Two credit rating agencies indicated further credit rating downgrades could be on the cards for SA, with Moody's specifically highlighting that "the Government proposal to more than double support to Eskom is credit negative" – Moody's is the last of the three key credit rating agencies to hold SA long-term debt on investment grade.

- Prior to SA's government comments on Eskom, the rand had convincingly strengthened past the R14.00/USD key resistance level on financial market expectations that the US will cut its interest rates this year by 50bp, with a 25bp cut expected to occur as early as this week.

- However, the special appropriation bill from the Finance Ministry, detailing an additional R59bn for Eskom over two years, was met with a negative reaction from the rand as both Moody's and Fitch signalled it increased the risk of further downgrades, with Moody's specifying "(i)f passed, the additional support … (to Eskom)… would be an additional drain on fiscal resources."

- In particular, Moody's worries that "South Africa's sluggish growth outlook limits its ability to absorb the extra cost of Eskom support", and that "(n)o clear strategic turnaround plan agreeable to all stakeholders has emerged yet, fuelling risks for the government of having to provide additional support".

- We have revised our probability of the lite down case to 35% from 25% as the likelihood of SA receiving a credit rating downgrade from Moody's is increasing, with the probability of the expected case falling to 45% from 50%, and that of the severe down case falling to 9% from 14% as the FOMC becomes increasingly dovish, and global growth risks reduce.

- In particular, Moody's says "(t)he likelihood is high for an upward revision in both the government spending ceilings and the fiscal deficits in the next MTBPS." "On the revenue side, weak tax performance in the last fiscal year coupled with … (low) … economic growth .. at 1% in real terms in 2019 also leaves limited room for adjustment on the revenue side."

- Moody's added that "(t)he government may try to absorb part of this extra cost with new revenue or expenditure measures in the next mid-year budget exercise, the Medium-Term Budget Policy Statement (MTBPS), expected on 23 October". However, higher taxes in SA (should they occur) would slow economic growth even further.

- On the expenditure side Moody's highlights that South Africa's "government has already embedded in its original budget several containment measures, including related to the wage bill, making further restraint difficult. The 2019 budget … raised contingency reserves … to accommodate financial support requests from the broader state-owned enterprises".

- The uncertainty around the source of the additional finance for Eskom, particularly given that government's expenditure commitments are high and difficult to reduce, has worried the rating agencies, leading to a weaker rand, coupled also with commentary from government around essentially 'partial nationalisation' of private sector health care under the NHI.

- The upwards revision of the probability attached to the lite down case has increased the risk of further weakness for the domestic currency this year and next, particularly given the downwards revision to the probability of the expected case, although the severe down case has seen a reduction in its likelihood as the chance of global recession has waned.

- Fitch revised SA's outlook to negative, signalling a potential downgrade to the credit rating on "marked widening in the budget deficit as a result of lower GDP growth and increased spending, including state-owned enterprise (SOE) support, increasing our projections for government debt/GDP and heightening the difficulty of stabilising debt/GDP over the medium term."

- In particular the agency says "(f)iscal metrics have deteriorated significantly due to under-performance of revenue, which is expected to worsen in the current fiscal year as growth has turned out to be weaker than expected" and "(u)pside risks to debt projections arise from 14.3% of GDP debt of non-financial SOEs".

- Furthermore Fitch highlights that "(l)ow GDP growth is increasingly weighing on South Africa's credit profile" and that "(l)ow trend GDP growth means that economic recovery is not expected to drive a major fiscal improvement in later years, while we also forecast expenditure to increase by approximately 2pp of GDP in FY19/20-FY21/22."

- Fitch expects that the “special appropriations bill … for government support to Eskom”, will cause “the consolidated general government (GG) deficit to widen to 6.3% of GDP FY19/20, significantly higher than the outcome of 4.2% for FY18/19 and the government's forecast of 4.5% for FY19/20 from the February budget.”

- In particular, Fitch projects “the GG deficit to decline to a still high 5.2% of GDP in FY21/22, still more than double the current 'BB' median deficit forecast of 2.3%.” With Fitch holding SA on a credit rating of BB+, the negative outlook implies the rating could fall to BB. Additionally, Fitch’s commentary indicates SA could be at risk of even further rating downgrades.

- This is concerning, as SA is facing downwards, not upwards pressure from the credit rating agencies, and lower credit ratings typically raise long and short-term interest rates, as well as causing currency depreciation. While a uniform sub-investment grade credit rating for SA from Moody’s, Fitch and S&P is significantly priced in, ongoing further downgrades are not.

- The National Health Insurance (NHI) Bill was also presented this month, with the draft law looking to create “a financing system that will make sure that all citizens of South Africa (and legal long-term residents) are provided with essential healthcare, regardless of their employment status and ability to make a direct monetary contribution to the NHI Fund.”

- This proposed universal healthcare system for SA is to be introduced incrementally to “offer all South Africans and legal residents access to a defined package of comprehensive health services. The state is committed to offering as wide a range of services as possible.”

- The exact details on the NHI are unclear, particularly regarding funding, operational mechanisms and impact on the private health care sector, while the creation of another SOE is regarded with scepticism by some as many SOEs are already battling financially. This has added to uncertainty in a weak investor climate, as have threats to SARB independence.

- Fitch adds that “(t)he credibility of the South African Reserve Bank (SARB) and its inflation targeting regime are an important credit strength” and Moody’s also sees the independence of SARB policy as a credit strength, particularly the “(s)ustained strength of core institutions such as the judiciary and the Reserve Bank”.

- With the FOMC likely to cut interest rates this week by 25bp the rand could once again track towards R14.00/USD, and indeed could break through this key resistance level in the last quarter of this year, and move into a more sustained range of R12.00/USD to R13.00/USD should SA avoid a Moody’s credit rating downgrade, although the chance of this has fallen.