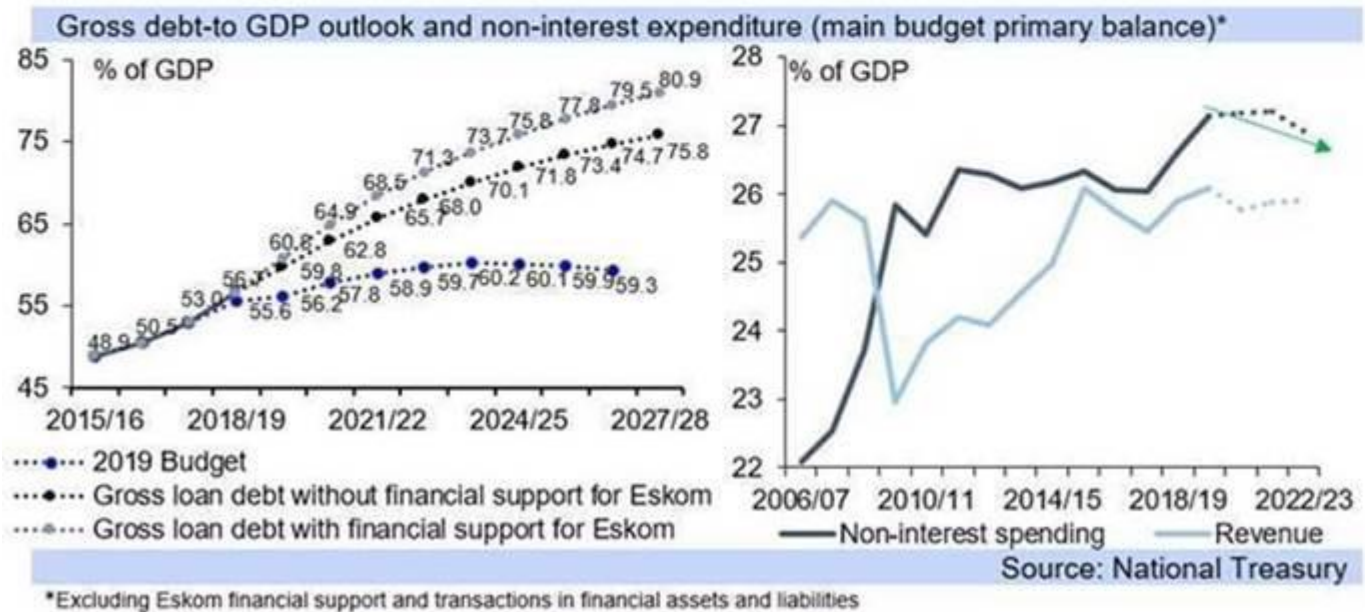
Investec

SA Economics

Credit Rating

Friday 1 November 2019

SA potentially is facing a country review from Moody's tonight, which will most likely see the outlook on SA's Baa3 rated debt dropped to negative, with an actual downgrade a second in probability



- South Africa will see a key credit rating decision from Moody's tonight (the agency is expected to deliver a review this time around) and while we continue to expect the agency will deliver a negative outlook on SA's rating, the possibility of receiving an actual downgrade is also material.

- Given the plans outlined to stabilise public finances outlined in the MTBPS (see MTBPS Snapshot: an extreme ramp up in debt to GDP projections makes a Moody's credit rating downgrade substantially more likely, 30th October 2019, see website address below) a ratings watch seems unlikely however.

- A negative outlook on SA's Baa3 rating would signal a rating downgrade in around eighteen months, unless factors change which would support a stable or positive outlook. A ratings watch shortens the time period to three months for the downgrade to the rating (of Baa3 to Ba1) to occur, if the ratings watch is not removed.

- The MTBPS outlined a number of key areas in which to reduce expenditure and stabilise public finances (rating agencies assess sovereigns ability to repay their debt), which would typically take longer than three months to complete (closer to a few years in a number of cases).

- With little possible in three months to turn around the projected debt and deficit picture outlined in the 2019 MTBPS, a ratings watch would likely be just a signal of an unavoidable, impending credit rating downgrade, and as such the agency could by the same token just effect the actual downgrade to sub-investment grade.

- The 2020 Budget in February will likely give a much clearer picture of whether the projections treasury has given to government on its finances, including those on civil service salary and wages, are likely. Civil servant remuneration sits around 45% of expenditure due to a near decade of above inflation increases.

- In particular, National Treasury aims for a primary balance (revenue equating non-interest expenditure) during the Medium-Term Expenditure Period (MTEF) by 2022/23, and indeed 2021/22 would already provide evidence of whether this fiscal target can be achieved, with fiscal performance over 2020/21 also key.

Credit ratings

	S & P	Moody's	Fitch	R & I
Investment grade	AAA	Aaa	AAA	AAA
	AA+	Aa1	AA+	AA+
	AA	Aa2	AA	AA
	AA-	Aa3	AA-	AA-
	A+	A1	A+	A+
	A	A2	A	A
	A-	A3	A-	A-
	BBB+	Baa1	BBB+	BBB+
	BBB	Baa2	BBB	BBB
	BBB-	Baa3	BBB-	BBB-
Sub-investment grade	BB+	Ba1	BB+	BB+
	BB	Ba2	BB	BB
	BB-	Ba3	BB-	BB-
	B+	B1	B+	B+
	B	B2	B	B
	B-	B3	B-	B-
	CCC+	Caa1	CCC	CCC+
	CCC	Caa2	CC	CCC
	CCC-	Ca3	C	CCC-
	CC	Ca	RD	CC
	C	C	D	C
	D	WR	WD	
	NR		PIF	

Source: Bloomberg

- The MTBPS says “(t)o stabilise the debt-to-GDP ratio over the coming decade, large additional measures are needed. … (to achieve the MTBPS projections)… (r)elative to the 2019 Budget, … (of the) … main budget non-interest spending increase(ing) by R23 billion in 2020/21 and decreases by R8.2 billion in 2021/22.

- The 2019 MTBPS further outlines that “(g)overnment is proposing a fiscal target: a main budget primary balance, excluding financial support for Eskom, by 2022/23. This will require reductions to wage bill growth. Tax measures are also being considered.”

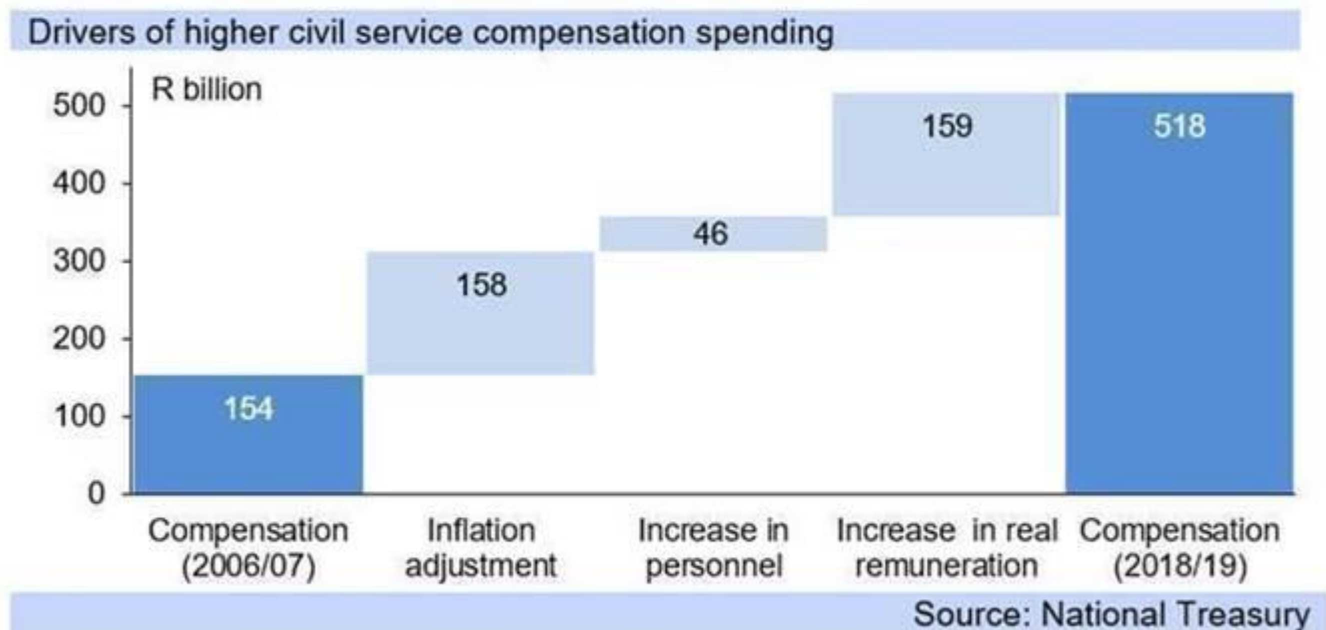
- “Spending reductions amounting to R49.5 billion over the next two years have been identified, and noninterest expenditure growth is limited to CPI inflation in the outer year. Nevertheless, total spending increases in the current year and in 2020/21, mainly due to financial support for Eskom.”

- Indeed, “(s)pending additions include financial support for Eskom and the reversal of estimated savings from compensation measures and the reorganisation of government, which were announced in the 2019 Budget.”

- The fiscal restraint is key, with expenditure cuts necessary as “following several years of tax increases, revenue options are constrained.” The tax-to-GDP ratio is close to its 2007/08 peak of 26.4 per cent, while the tax buoyancy ratio is not projected at a robust ratio in the MTEF.

- The MTBPS also said “(t)he 2019 Budget included R10 billion in tax increases for 2020/21. The tax policy measures to raise this amount will be announced in the 2020 Budget.” We expect failure to adjust for bracket creep will account for the majority of this collection, with likely a top marginal tax rate increase.

- “Government proposes a path to restore the public finances to a sustainable position. This will mainly involve a range of expenditure reductions, some of which are likely to be painful. We owe it to future generations to ensure that we are good stewards of our country’s resources and that they do not have to pay for our decisions.”



- The 2019 MTBPS is not an austerity package, the 2020 Budget will outline the necessary measures to achieve the fiscal consolidation required from a tax and expenditure perspective. However, after a near decade of substantial fiscal expansion SA’s finances cannot sustainably expand further.

- "Additional measures, particularly on the wage bill, will be required to narrow the deficit and improve the composition of spending." "Growth in the public-service wage bill needs to decline to reduce the pressure on goods and services and infrastructure." "The final adjustments will be announced in the 2020 Budget."

- "These measures require difficult decisions that will affect the economy and the distribution of public resources. The short-term costs, however, are outweighed by the need to ensure sustainable public finances for decades to come, ensuring intergenerational fairness."

- South Africa has undergone a structural slowdown in economic growth since 2011, aided by a substantial increase in the regulatory burden which has substantially reduced the ease of doing business. Additionally markedly higher direct and indirect taxes have also quelled growth, while fiscal stimulus has supported it.

- Substantial, above-inflation rolling salary and wage increases for public sector service employees have also added to the huge escalation in debt (which is borne by future generations), and quelling the growth in this current expenditure area is key as above inflation increases are no longer affordable.

- Clawing "back some of the revenue shortfall through reductions to departmental baselines and slower spending growth in the outer year of the medium-term expenditure framework (MTEF)" is projected. But the MTBPS calculates that "(a)lone, these reductions are insufficient."

- Failure of a social compact in South Africa to limit public sector employees to salary and wage increases at or below CPI inflation will clearly imperil the ability of South Africa to achieve its fiscal target as per the 2019 MTBPS, and so avoid many (as opposed to only one from Moody's) credit rating downgrades.

South Africa – S&P Ratings	
03/10/1994	BB
20/11/1995	Upgraded to BB+
25/2/2000	Upgraded to BBB-
07/05/2003	Upgraded to BBB
01/08/2005	Upgraded to BBB+
12./10/2012	Downgraded to BBB
13/06/2014	Downgraded to BBB-
03/04/2017	Downgraded to BB+
24/11/2017	Downgraded to BB

South Africa – Fitch Rating	
22/09/1994	BB
19/05/2000	Upgraded to BB+
27/06/2000	Upgraded to BBB-
05/02/2003	Upgraded to BBB
25/08/2005	Upgraded to BBB+
10/01/2013	Downgraded to BBB
04/12/2015	Downgraded to BBB-
07/04/2017	Downgraded to BB+

South Africa – Moody's	
14/10/2004	Baa2
11/01/2005	Upgraded to Baa1
16/07/2009	Upgraded to A3
27/09/2012	Downgraded to Baa1
06/11/2014	Downgraded to Baa2
09/06/2017	Downgraded to Baa3

- "Moody's has already said South Africa's "(g)overnment proposal to more than double support to Eskom is credit negative … because it would be an additional drain on fiscal resources." The MTBPS saw assistance rendered to Eskom.

- "In a worst-case scenario where none of this additional support is compensated for, South Africa's fiscal deficit would widen to 5.7% of GDP in fiscal 2019 and 5.6% in fiscal 2020, up from our current projections of 5.2% of GDP in fiscal 2019 and 5.0% in fiscal 2020, worsening the upward trend on government debt."

- The 2019 MTBPS projects the fiscal deficit as a % of GDP ratios even higher, at -5.9% of GDP for 2019/20 (previously expected at -4.5%), -6.5% of GDP for 2020/21 (previously -4.3%), -6.2% in 2021/22 (previously -4.0%) and -6.2% in 2022/23.

- Moody's added "(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, but we think its room to maneuver is extremely constrained."

- "On the spending side, the government has already embedded in its original budget several containment measures, including related to the wage bill, making further restraint difficult. The likelihood is high for an upward revision in both the government spending ceilings and the fiscal deficits in the next MTBPS."

- "Further balance sheet support under a debt transfer as requested by Eskom in December 2018 or off-balance sheet support such as a step-up in the ZAR350 guarantee envelope for Eskom debt, remain additional risks to South Africa's fiscal strength."

- "No clear strategic turnaround plan agreeable to all stakeholders has emerged yet, fuelling risks for the government of having to provide additional support." The recent announcements on Eskom are not deemed on their own sufficient to repair the entity's finances.

Local Currency – Long term			
	S&P	Moody's	Fitch
Brazil	BB-	Ba2	BB-
Russia	BBB	Baa3	BBB
India	BBB-	Baa2	BBB-
Turkey	BB-	B1	BB-
Mexico	A-	A3	BBB
South Africa	**BB+**	**Baa3**	**BB+**
China	A+	A1	A+
Nigeria	B	B2	B+
Kenya	B+	B2	B+
Namibia	NR	Ba1	BB
Ghana	B	B3	B
Botswana	A-	A2	NR
Mozambique	B-	Caa2	CC
Zambia	CCC+	Caa2	CCC
Ethiopia	B	B1	B
Rwanda	B+	B2	B+
Uganda	B	B2	B+
Angola	B-	B3	B
Dem. Rep of Congo	CCC+	Caa1	NR
			Source: Bloomberg

Foreign Currency – Long term			
	S&P	Moody's	Fitch
Brazil	BB-	Ba2	BB-
Russia	BBB-	Baa3	BBB
India	BBB-	Baa2	BBB-
Turkey	B+	B1	BB-
Mexico	BBB+	A3	BBB
South Africa	**BB**	**Baa3**	**BB+**
China	A+	A1	A+
Nigeria	B	B2	B+
Kenya	B+	B2	B+
Namibia	NR	Ba1	BB
Ghana	B	B3	B
Botswana	A-	A2	NR
Mozambique	SD	Caa2	RD
Zambia	CCC+	Caa2	CCC
Ethiopia	B	B1	B
Rwanda	B+	B2	B+
Uganda	B	B2	B+
Angola	B-	B3	B
Dem. Rep of Congo	CCC+	Caa1	NR
			Source: Bloomberg

- Moody's added "(o)n the revenue side, weak tax performance in the last fiscal year coupled with our expectation that economic growth will remain low at 1% in real terms in 2019 also leaves limited room for adjustment on the revenue side."

- A ratings reaction is therefore widely expected from Moody's, and the risk of an outright ratings downgrade, is high. If South Africa's credit rating is downgraded, this would see it rated sub-investment grade from all three of the key rating agencies.

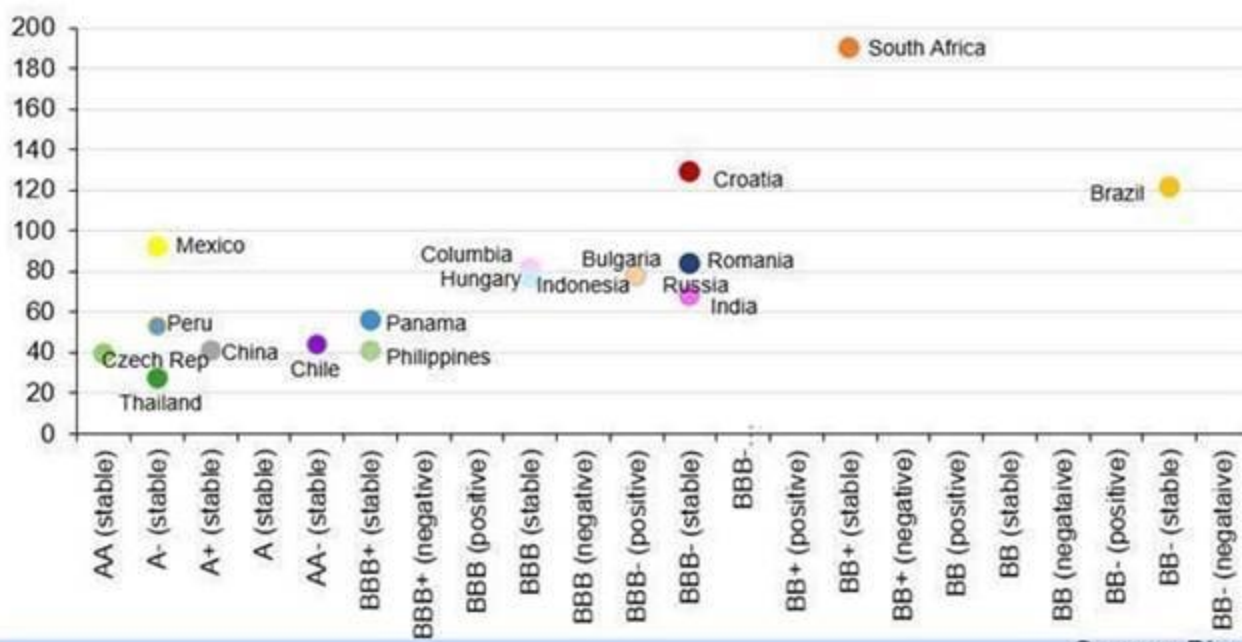
- Should SA receive such a credit rating downgrade (to sub-investment grade from Moody's), it is key to understand the likely economic and market impact. A number of countries display(ed) similar characteristics to South Africa experiencing upgrades and downgrades in similar periods, and have (had) similar yields.

- First however, the key point is that for the performance of market indicators under a significant (severe) credit rating downgrade (from investment to sub-investment grade) is the prevailing nature of global financial market sentiment, specifically whether there is a risk-on (risk taking) or risk-off (risk averse) period.

- During risk-off, the negative impact on the country's currency, bond yields, short-term money market rates and other indicators can be quite pronounced. In risk-on, the market impact is likely more muted than in risk-off. However, what is also key is how much of the downgrade has already been factored in by markets.

- In the previous transition from investment to sub-investment grade for Brazil, Turkey, Russia and Hungary on average at the point of downgrade the 10 year government bond yields rise by about 130bp on average versus the previous three months. We do not anticipate such an elevation in yields.

- The credit default swaps price SA at sub-investment grade, while the yield on SA's ten year benchmark government bond is at 9.10% from close to 6.0% in 2013, as successive credit rating downgrades were factored in, and occurred. We estimate a rise towards 10% in the yield if a ratings downgrade occurs tonight.



- Sentiment in global financial markets can have a material impact on the outcome. Globally risk aversion levels are not elevated to the degree in 2018, and this, together with fact that markets have increasingly factored in a Moody's credit rating downgrade for SA over the last few years should limit market reaction.

- In the country analysis, short-term interest rates rose by about 220bp on average versus the previous three months. After three months they dropped by about 80bp on average, and then another 20bp six months later, but were still above a year prior. We estimate around a 60bp rise if a ratings downgrade occurs tonight.

- At the point of downgrade the currency depreciated by about 13% on average for these countries versus the previous three months. After three months it appreciated by about 11% on average, and then appreciated by around 8% six months later, but was weaker than a year prior (see scenario table).

- At the point of downgrade CPI rose by about 3% y/y on average versus the previous three months. After three months it dropped by about 0.1% y/y, then by about 0.2% y/y six months later. The pass through effect in SA has proved reduced in recent years and less upwards pressure would be anticipated for SA's CPI.

- At the point of downgrade GDP contracted by about 1.1% on average versus the previous three months. After three months it expanded by about 0.3% on average. Inflation rate evidence is also poor, and tends to follow currency impact.

- However, globally evidence is generally difficult to detach from other events, and so causality (whether the economic slowdown occurs because of the credit rating downgrade, or whether the credit rating downgrade causes the economic slowdown) is mixed.

- Our expected case is for Moody's to drop the outlook to negative on SA's sovereign credit rating to negative, but not drop the credit rating to sub-investment grade this year. Much however will depend on whether the agency believes that govern can affect the repair outlined in the 2019 MTBPS.

Economic Scenarios: - note updated table

Scenario		Q1.19	Q2.19	Q3.19	Q4.19	Q1.20	Q2.20	Q3.20	Q4.20
Extreme Up case 1%	Rand/USD (average)	14.01	14.38	14.69	11.50	10.30	9.50	8.60	7.90
	Repo rate (end rate)	6.75	6.75	6.50	6.00	6.00	5.75	5.75	5.50

Fast, sustainable economic growth of 5-7% y/y. Change in political will with growth creating economic reforms that structurally lift private sector investor confidence and fixed investment. Global growth boom (including commodities), Trump protectionism removed, SA export and domestic growth boom lifts employment and incomes, poverty eventually eliminated. Property rights strengthened, individuals obtain title deeds in EWC without disruption to economy. Fiscal consolidation, credit rating upgrades to A grade.

Scenario		Q1.19	Q2.19	Q3.19	Q4.19	Q1.20	Q2.20	Q3.20	Q4.20
Up case 7%	Rand/USD (average)	14.01	14.38	14.69	13.00	11.50	10.00	9.95	9.90
	Repo rate (end rate)	6.75	6.75	6.50	6.25	6.25	6.25	6.00	6.00

Persistent growth of 3–5%, higher probability of extreme up case. Better governance, growth-creating reforms (structural constraints overcome), greater socio-economic stability, strengthening in property rights, individuals obtain title deeds in EWC without disruption to economy and can leverage and obtain credit. High business confidence and fixed investment growth, substantial FDI inflows, fiscal consolidation. Strong global growth and commodity cycle, 'trade war' subsides. Stabilisation of credit ratings, with ultimately credit rating upgrades.

Scenario		Q1.19	Q2.19	Q3.19	Q4.19	Q1.20	Q2.20	Q3.20	Q4.20
Base case 39%	Rand/USD (average)	14.01	14.38	14.69	14.80	14.90	14.75	14.55	14.30
	Repo rate (end rate)	6.75	6.75	6.50	6.50	6.50	6.50	6.50	6.50

Annual growth approaches 2.0% y/y by 2021. Rising confidence and investment levels over the five-year forecast period. SA retains one investment grade (Moody's) rating on its local currency long-term sovereign debt in 2019 and 2020 on a negative outlook. Avoids severe global risk-off environment, neutral to global risk-on. Modestly strengthening global demand to trend growth. Limited impact of EWC (expropriation without compensation) to abandoned, unused, labour tenets and government land (individuals are new owners and receive title deeds) does not have a negative effect on economy.

Scenario		Q1.19	Q2.19	Q3.19	Q4.19	Q1.20	Q2.20	Q3.20	Q4.20
Lite (domestic) Down case 38%	Rand/USD (average)	14.01	14.38	14.69	15.80	16.50	16.30	15.50	15.15
	Repo rate (end rate)	6.75	6.75	6.50	6.75	7.25	7.25	7.25	7.25

SA is rated sub-investment grade by Moody's but substantial repair avoids further marked downgrades. Business confidence depressed, marked rand weakness, significant load shedding and weak investment growth until substantial repair effected. V shaped, credit rating downgrade-related recession. However, a neutral to risk-on global financial market environment (the international environment is that of the base case) lessens the impact of the rating downgrade. Potentially combined with a modest expropriation of some private commercial sector property without compensation, with limited impact on economy.

Scenario		Q1.19	Q2.19	Q3.19	Q4.19	Q1.20	Q2.20	Q3.20	Q4.20
Severe down case 15%	Rand/USD (average)	14.01	14.38	14.69	16.10	18.50	19.50	20.00	19.25
	Repo rate (end rate)	6.75	6.75	6.50	7.00	7.75	8.50	9.25	10.00

Continued global sharp economic slowdown resulting in a global recession, on a marked escalation of the US-China trade war – may include a global financial crisis. SA rated sub-investment grade from all three key agencies, with further rating downgrades. A significantly more severe recession occurs in SA than in the lite down case, marked rand weakness, may eventually include widespread services load shedding and strike action. Potentially combined with expropriation of private sector property (title deeds not transferred to individuals' nationalisation) without compensation – severe negative impact on economy.

Note: Event risk begins Q4.19. Source: Investec, Iress historical data