MOODY'S
INVESTORS SERVICE

Rating Action: Moody's downgrades South Africa's ratings to Ba2, maintains negative outlook

20 Nov 2020

Paris, November 20, 2020 -- Moody's Investors Service ("Moody's") has today downgraded the Government of South Africa's long-term foreign-currency and local-currency issuer ratings to Ba2 from Ba1. It maintained the negative outlook in place since 1 November 2019.

Moody's also downgraded South Africa's long-term foreign-currency and local-currency senior unsecured debt ratings to Ba2 from Ba1, its provisional senior unsecured MTN programme and senior unsecured Shelf foreign-currency ratings to (P)Ba2 from (P)Ba1 and affirmed the provisional other short-term foreign-currency rating at (P)NP.

The key driver behind the rating downgrade to Ba2 is the further expected weakening in South Africa's fiscal strength over the medium term. Whereas the rating action earlier in 2020 reflected an erosion in the country's credit profile which predated the coronavirus crisis, today's action reflects Moody's assessment of the impact of the pandemic shock, both directly on the debt burden and indirectly by intensifying the country's economic challenges and the social obstacles to reforms. While South Africa is not alone in having been severely affected by the crisis, its capacity to mitigate the shock over the medium term is lower than that of many sovereigns given significant fiscal, economic and social constraints and rising borrowing costs. In recent years, the government's strategy has rested on structural reforms to promote medium-term growth as well as on fiscal consolidation. However, while the strategy remains in place, implementation risks have risen materially.

The maintenance of the negative outlook reflects the risks that the debt burden and debt affordability could deteriorate significantly more than Moody's currently projects. This partly reflects downside risks to both growth and the fiscal consolidation assumed in the baseline. It also reflects the potential for further financial demands from state-owned enterprises (SOEs) or for higher interest rates given possible shocks to confidence. If these risks were to materialise, the rise in the government debt burden would become increasingly difficult to slow down let alone reverse.

South Africa's long-term local-currency bond and bank deposits ceilings were lowered to Baa1 from A3, as well as the long-term foreign-currency bond and bank deposits ceilings to respectively Baa2 and Ba2 from Baa1 and Ba1. The short-term foreign-currency bond and bank deposits ceilings remain unchanged at respectively P-2 and NP.

RATINGS RATIONALE

RATIONALE FOR THE RATING DOWNGRADE TO Ba2

FISCAL CHALLENGES HAVE INTENSIFIED AND WILL PERSIST FOR LONGER

The coronavirus shock has intensified South Africa's fiscal challenges and exacerbated the upward trend in its government debt burden, which predate the coronavirus crisis. Moody's now projects government debt-to-GDP to rise to 110% by the end of fiscal year (FY) 2024 - including SOEs guarantees - equivalent to a 40 percentage point increase from FY2019.

The crisis will leave long-term scars on South Africa's fiscal position principally through two channels: a severe loss in revenue of about 5% of GDP, which the government cannot fully and quickly compensate through spending cuts nor recover; and rising borrowing costs. The government will register a wider deficit for FY2020 than Moody's expected earlier in March when it downgraded South Africa's ratings to Ba1 from Baa3, and wider deficits will persist into the medium term, resulting in a markedly steeper and more prolonged increase in the debt burden than expected in March.

In FY2020, Moody's forecasts the fiscal deficit for South Africa at about 15% of GDP, in line with the government's own budget plan last laid out in its October Medium Term Budget Policy Statement. This forecast assumes that the government will be able to adhere to its budgeted spending, especially as regards the wage bill. Its ability to do so is questionable. For example, the government aims to limit the increase in the wage bill to 2% this year, which is below inflation and the rate set under the three-year agreement on public sector wages running for fiscal years 2018-2020, a decision that unions have contested in court.

From FY2022, interest costs will become the main contributor to debt-to-GDP increases, reducing fiscal flexibility further. South Africa's government debt affordability, measured as the portion of revenue needed to cover interest payments, will deteriorate to 25% in the medium term.

AS HAVE ECONOMIC AND SOCIAL CONSTRAINTS TO THE GOVERNMENT'S GROWTH STRATEGY

South Africa is not alone in having been severely affected by the crisis. However, its capacity to mitigate the shock over the medium term is lower than that of many sovereigns given significant fiscal, economic and social constraints which exacerbate the pressures from rising borrowing costs. In recent years, promotion of potential growth has been a key plank in the government's strategy to address rising debt. However, while the strategy remains in place, implementation risks have risen materially.

South Africa's economic growth will likely remain structurally low at around 1% in real terms over the medium term, exacerbating the country's fiscal challenges. This in itself is not new; low potential growth pre-dates the coronavirus shock. However, Moody's expects the crisis to intensify South Africa's long-standing economic and social constraints, making reforms even more challenging to implement and posing further risks to medium-term growth.

While the government has advanced several reforms, including for instance to fight corruption, the labour market continues to be plagued by rigidities. The resulting high unemployment rates will likely worsen as a result of the coronavirus shock. In turn, the country's income inequalities, already among the highest globally prior to the crisis, are likely to intensify, which in turn will hinder reform implementation and weigh on growth. The severe economic and social shock is likely to exacerbate the preexisting frictions between government, corporates and trade unions, further impeding reform implementation.

NEGATIVE OUTLOOK

The maintenance of the negative outlook reflects the risks that the debt burden and debt affordability could deteriorate significantly more than Moody's currently projects. This partly reflects downside risks to both growth and the fiscal consolidation assumed in the baseline. It also reflects the potential for further financial demands from state-owned enterprises (SOEs) or for higher interest rates given possible shocks to confidence. Eskom Holdings SOC Limited (B3 negative) remains a particular source of further contingent liability risk for the government; a solution to its financial viability which addresses its high debt level, 65% of which is government-guaranteed, remains incomplete, but could itself also lead to a further deterioration in government finances. If these risks were to materialise, the rise in the government debt burden would become increasingly difficult to slow down let alone reverse.

ENVIRONMENTAL, SOCIAL, GOVERNANCE CONSIDERATIONS

Environmental considerations exert material influence on South Africa's credit profile, mainly reflecting physical climate risk and water shortages. Due to its geographical location, South Africa is subject to frequent climate-related shocks such as droughts which undermine the agricultural sector's performance and have weighed on growth in recent years. That said, the country's economic diversification and sophisticated agricultural techniques mitigate the impact of environmental considerations on South Africa's credit profile.

Social considerations have a high impact on South Africa's credit profile and their implications for the economy and public finances are a driver of today's rating action. Deep socio-economic inequalities complicate the implementation of reforms which would otherwise unlock the economy's potential and contribute to tensions that fuel political risk.

Governance considerations are moderately supportive of South Africa's credit profile. South Africa's ranking under the Worldwide Governance Indicators is stronger than Ba2-rated sovereigns, and the strength of key institutions, in particular the South African Reserve Bank and the Treasury, continue to support the rating. However, set against those qualities, the broader erosion in institutional strength induced by the corruption of the Zuma administration, and in particular in fiscal policy effectiveness, is an important factor behind the erosion in South Africa's credit profile in recent years.

GDP per capita (PPP basis, US$): 12,962 (2019 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 0.2% (2019 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 4% (2019 Actual)

Gen. Gov. Financial Balance/GDP: -6.4% (2019 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: -3% (2019 Actual) (also known as External Balance)

External debt/GDP: [not available]

Economic resiliency: baa3

Default history: At least one default event (on bonds and/or loans) has been recorded since 1983.

On 17 November 2020, a rating committee was called to discuss the rating of the South Africa, Government of. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have not materially changed. The issuer's institutions and governance strength, have materially decreased. The issuer's fiscal or financial strength, including its debt profile, has materially decreased. The issuer's susceptibility to event risks has not materially changed.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

A rating upgrade is unlikely in the near future given the negative outlook.

Moody's would likely change the rating outlook to stable if it were to conclude that the government's efforts to consolidate its fiscal position were likely to slow and eventually arrest the rise in the debt burden and contribute to reducing the cost of debt. Any such outcome would likely rest on a slow but durable pick-up in growth, at least partly as a result of meaningful and effective labour market or power sector reforms, and a steadily-narrowing fiscal deficit. On the fiscal side, an agreement with the unions which substantially moderates future increases in the wage bill would also be supportive.

Moody's would likely downgrade South Africa's ratings if it concluded that its debt burden, and the related pressure on debt affordability, were likely to rise materially faster and for longer than currently assumed. That conclusion could reflect further difficulties in implementing growth-enhancing reforms, ongoing shocks to primary expenditure or revenues or sustained rises in the level or volatility of interest rates. Any indication of diminished access to funding at interest rates that would further endanger the government debt sustainability would put significant downward pressure on the rating.

The principal methodology used in these ratings was Sovereign Ratings Methodology published in November 2019 and available at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1158631 . Alternatively, please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found at: https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004.

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Regulatory disclosures contained in this press release apply to the credit rating and, if applicable, the related rating outlook or rating review.

Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1133569 .

Please see www.moodys.com for any updates on changes to the lead rating analyst and to the Moody's legal entity that has issued the rating.

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