The Macro Research Desk


Herman van Papendorp
Head of Investment Research & Asset Allocation


Sanisha Packirisamy
Economist

Moody's favourably reverses South Africa's credit rating outlook from negative to stable

Highlights

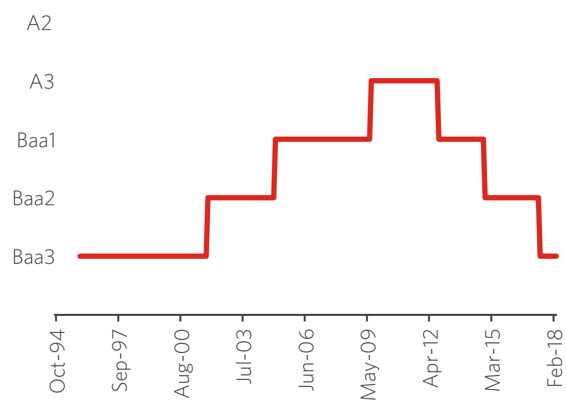
- Moody's kept South Africa's (SA) foreign and local currency rating unchanged at Baa3, in line with expectations, which left the country eligible for inclusion in the Citigroup World Government Bond Index (Citi WGBI).
- The favourable credit rating outlook reversal from negative to stable was unlikely fully priced in by markets.
- A likely return to a more transparent and predictable policy-making environment was cited as the main reason behind Moody's rating decision.
- The stable outlook reflected a balance of risks (opportunities and challenges) faced by the new administration.
- A resolution to the mining charter debate and a balanced approach to land restitution will test the new administration's ability to address conflicting political priorities.
- Addressing institutional problems and successfully implementing structural reforms could lead to a ratings upgrade.
- A faltering commitment to revived growth and debt stabilisation could lead to SA's credit rating outlook being dropped to negative again.

A more predictable policy-making environment allowed Moody's to keep its rating unchanged

In its June 2017 review, Moody's downgraded SA's sovereign credit rating to Baa3 on fiscal sustainability and economic concerns (see chart 1). Following the release of National Treasury's sombre medium-term budget policy statement in October 2017, Moody's decided to place SA on review for downgrade in its 24 November 2017 review, citing a volatile political scenario, poor economic growth and a lack of a clear direction in policy as key concerns underlying its earlier decision.

Since then, Moody's noted economic and fiscal challenges have become less pronounced, arresting a further deterioration in the country's creditworthiness. Moreover, the new administration has attempted to begin to restore institutional credibility at some of SA's key institutions, through an ongoing investigation into state capture. Moody's noted the country was likely to return to a more transparent and predictable policy-making environment.

Chart 1: Moody's SA sovereign credit rating over time



Source: Moody's, Bloomberg, Momentum Investments, data up to March 2018

Political challenges remain a risk to economic success

Moody's noted its decision to reverse the sovereign's credit rating outlook, from negative to stable, reflected the balance of risks faced by the new administration. While the new administration faces the prospect of higher economic growth, rising social cohesion and greater fiscal consolidation, the practical and political challenges of meeting these goals (while appeasing all constituents) remain a challenge.

Moody's recognised the broad nature of the policy agenda and noted certain elements of the agenda have the "potential to create tensions within the administration and society". In the run up to the 2019 national elections, voter perception of economic and socio-political success will remain key and, as such, Momentum Investments expects the debate on land reform to remain a fundamental risk to investor and business sentiment. With respect to land restitution, the rating agency acknowledged the intricate balance between sustaining confidence in the short term with addressing poverty and inequality in the long term, all while ensuring agricultural production and food security.

Moody's argued a successful resolution to the mining charter debate will further be a test of the ruling party's ability to reach compromises to push through reform in the mining sector.

A halt in the deterioration of institutional credibility and some rebuilding highlighted

Moody's drew attention to the ongoing strength of SA's media, civil society, the SA Reserve Bank (SARB) and the judiciary, and noted a number of institutions had embarked on a journey to restore their institutional strength. Positive changes in governance, key institutions (namely National Treasury and the SA Revenue Service (SARS)) and some state-owned enterprises (SoEs) were taken note of. As such, the effectiveness of critical policy-making institutions and economic confidence around policy making are expected to favourably reverse towards its former standing.

The rating agency pointed out the speed at which the new president moved to replace the leadership in vital ministries and institutions (namely finance, mineral resources, public enterprises and SARS) illustrated a resolve to shift the country to a new, positive path.

Nonetheless, Moody's acknowledged SA's deep economic, fiscal and social challenges by suggesting the reform agenda, set out in the president's State of the Nation Address (SONA), was ambitious.

An improvement in economic activity and firmer growth prospects were further highlighted as reasons behind Moody's rating decision. The SARB's recent growth revisions suggested the country did not enter a technical recession recently and, instead, actual growth was higher than initially expected. Moody's suggested higher expected growth this year would award government with additional fiscal and political space to pursue economic reforms.

Although the sharp recovery in confidence was pointed out as being positive, Moody's emphasised the need to sustain higher levels of confidence through a continued implementation of structural reforms. The reforms, according to Moody's, must include progress in mining, energy, SoEs and competition.

In addition, Moody's noted the February 2018 national budget outlined a clear strategy to reduce fiscal pressures and adjusted its projections to reflect an expected stabilisation in government's debt-to-GDP (gross domestic product) ratio at 55% between 2018 and 2020. Together, higher economic growth, a restraint on expenditure, a broader revenue base and an improvement in SARS' collection capacity (likely driven by a change in leadership and an improvement in tax morality, in line with government's increased efforts to curb corruption) are expected to drive a stabilisation (and ultimate reversal) in SA's debt ratio.

The rating agency was comforted by the material cuts made to government's expenditures (outside of the additional spending allocated to free higher education) and government's willingness to make a front-loaded fiscal adjustment. Moreover, Moody's mentioned the increase in value-added taxes signalled "a marked, and credit positive, policy shift".

That said, Moody's raised concerns over government's ability to make inter-departmental expenditure cuts, particularly with regards to civil servant wages. It also remained concerned over material risk arising from government's contingent liabilities, specifically noting the "fragile state" of public energy utility, Eskom.

Positive ratings action needs institutional problems addressed and reform implementation

According to Moody's, a ratings upgrade would require government to effectively address institutional problems and implement its reform agenda. Through reform, potential growth could rise, alleviating fiscal pressure. A rebuilding of SA's fiscal buffers and a reduction in contingent liabilities are possible in a higher growth environment, where revenue potential is boosted.

Moody's further requires progress on long-standing structural issues, in mining and agriculture, in particular, to consider a ratings upgrade.

Negative ratings action could be triggered by a faltering commitment to revived growth and debt stabilisation

Should government's commitment to revived growth and debt stabilisation falter, Moody's would likely react by dropping SA's sovereign rating outlook back to negative, from stable. The delivery of structural reforms between now and the 2019 national elections and its consequent effect on investor and business confidence will continue to weigh on SA's rating, given the implications for near-term and potential growth.

Moody's continued to highlight negative fiscal developments as a trigger for an outlook reversal to negative. These included SoE risks materialising, which would place a larger burden on SA's debt trajectory.

SA dodges an expulsion from the Citi WGBI

Although investor confidence has been lifted by a better-than-expected growth outcome for 2017 and a number of positive political and fiscal developments since the market-favourable outcome of the African National Congress (ANC) National Conference in December 2017 (including the appointment of credible ministers in key ministries, leadership issues being addressed at SARS, an ongoing investigation into state capture and a brighter, but still credible, fiscal outlook announced in the February 2018 national budget), there is still a non-negligible risk of a change in Moody's outlook on SA from stable back to negative on 12 October 2018.

The sustainability of business and consumer confidence will be dependent on the new administration's ability to keep the momentum behind the implementation of structural economic and political reforms, to usher in an era of higher growth.

Investors will be seeking clarity on the adoption of land reform without expropriation as a policy of the ruling party and will remain vigilant of signs that the rule of law has been reinstated in the country, through the conviction of a number of individuals involved in high-profile corruption cases.

Despite governance issues having been addressed at key parastatals, a more sustainable funding solution for ailing SoEs needs to be finalised to lower the risks to Treasury's contingent liabilities being absorbed onto government's balance sheet.

A downgrade in SA's local currency rating to junk status by Moody's would have triggered SA's exclusion from the Citi WGBI, which could have prompted significant capital outflows from the SA government bond market. Estimates of potential outflows ranged anywhere between R85 billion and R130 billion.

Citi noted that, while SA bond buying by foreign investors in the run up to the 2012 index inclusion might have been staggered, the rush for the exit door could have been crowded. Furthermore, re-entry into the index, once being excluded, is difficult to achieve. The Citi WGBI requires a minimum credit quality of A- by S&P and A3 by Moody's for the country's local currency rating (four notches above junk status).

Standard & Poor's (S&P) is expected to review SA on 25 May 2018, while Fitch Ratings has not released its review dates for SA. While under its base case scenario, Momentum Investments does not expect further negative ratings action from S&P in its upcoming review, a ratings outlook upgrade will remain dependent on S&P's growth forecasts and progress on growth in GDP per capita trends.

Table 1: SA sovereign ratings matrix

Long-term rating	S&P	Fitch	Moody's
Investment grade	A-	A-	A3
	BBB+	BBB+	Baa1
	BBB	BBB	Baa2
	BBB-	BBB-	Baa3
Sub-investment grade	BB+	BB+	Ba1
	BB	BB	Ba2
Outlook	Stable	Stable	Stable

Local currency rating
Foreign currency rating
Both ratings

Source: S&P, Moody's, Fitch, Momentum Investments