The Macro Research Desk

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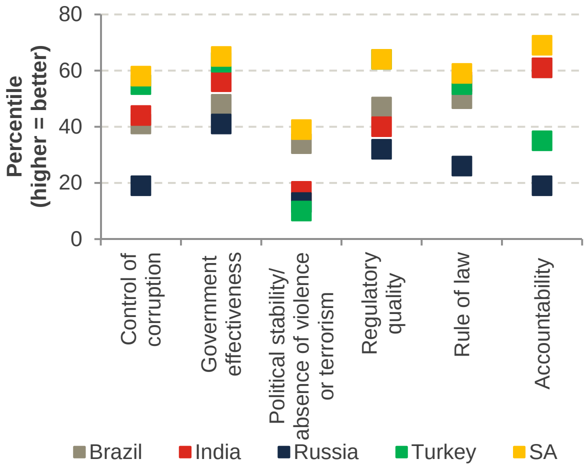
Fitch and Moody's ratings reviews – political instability is a shared concern

Fitch lowered its outlook to negative, but the rating remains unchanged for Fitch and Moody's

Fitch Ratings lowered its outlook on SA's long-term sovereign debt rating to negative from stable, but kept the rating intact at BBB-. Moody's, which rates SA one notch higher than S&P Global Ratings or Fitch at Baa2, left the rating (and the negative outlook on the rating) unchanged. A common concern voiced by both ratings agencies was the current state of political affairs in SA. SA's potential growth profile and overall governance could be negatively affected by political infighting, distracting policymakers from adhering to sound fiscal management and maintaining a healthy investment climate through the implementation of growth-enhancing policy initiatives. Despite Fitch suggesting (in its December 2015 ratings review) SA ranked higher than its peers on the World Bank Governance Indicator, it noted that recent political tensions may not be adequately addressed in the most recent results for 2015 (see chart 1).

Chart 1: World Bank Governance Indicator breakdown for SA and its peer group



Source: World Bank, Momentum Investments

With many indicators of economic development in SA (including average five-year gross domestic product (GDP) growth, the current account deficit and the share of net external debt as a proportion of GDP) falling short of its peer group, broad political/institutional stability and macro policy continuity remain key in preserving SA's investment grade status.

Prudent monetary policy, quality fiscal institutions and SA's floating exchange rate regime (acting as a shock absorber) have in the past been noted as vital pillars of strength in SA. However, rising perceptions of political interference in key spheres of government institutions threaten SA's macroeconomic performance, public finances and consequently the ratings outlook.

Negative outlook in both cases suggests an upgrade is unlikely at this stage

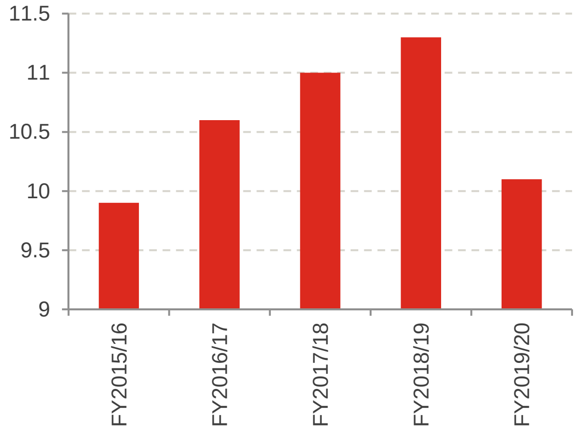
Fitch and Moody's have warned that the current negative outlook suggests little chance of an upward adjustment in SA's credit rating, but have outlined a number of economic outcomes which need to materialise to prevent a downgrade (see table 1).

Table 1: Comparison between Fitch's and Moody's ratings reviews

	Fitch review	Moody's review
Outcome	• Sovereign: Stable at BBB- (outlook deteriorated from stable to negative) • Local: Stable at BBB-	• Sovereign: Stable at Baa2 (negative outlook maintained) • Local: Stable at Baa2
Reasons behind outcome	• Increased political risks to governance and policymaking ➔ risks to remain high into ANC electoral conference in December 2017 ➔ undermines macroeconomic performance • Political infighting will distract policymakers ➔ poor investment climate ➔ growth constraint • Public protector report underlines risks to governance in state-owned enterprises (SoEs) • Factional battles could prevent streamlining of SoE portfolio • Indicators of economic development weaker than peer group	<u>Rating unchanged:</u> • Track record of sound fiscal management • Primary surplus in sight • Adherence to expenditure ceiling <u>Outlook remains on negative</u>: • Contingent liabilities a threat in the run up to the 2019 national elections • Delays to growth improvement • Political uncertainty suppressing business confidence • Challenging external environment (i.e. trade conditions)
Triggers for potential negative ratings action	• Continued political instability ➔ adverse effect on the economy, governance and public finances • Failure to stabilise government debt ratio • Failure to prevent a further increase in contingent liabilities • No sustainable GDP recovery as a consequence of policy uncertainty • Rising external debt levels (currently below government's benchmark, see chart 2)	• Failure to reinvigorate business confidence • Accumulation of public debt and a rise in contingent liabilities • Political infighting impeding reform momentum
Triggers for potential positive ratings action	• Record of improved growth • Marked narrowing of budget deficit • Decline in government debt ratio • Narrowing current account deficit • Decline in net external debt ratio	• Implementation of fiscal consolidation targets • Structural reforms in labour markets, electricity sector and SoEs • Stabilising debt ratio (including contingent liabilities)

Source: Fitch, Moody's

Chart 2: Projected net external debt to GDP comfortably below government's 15% benchmark (%)

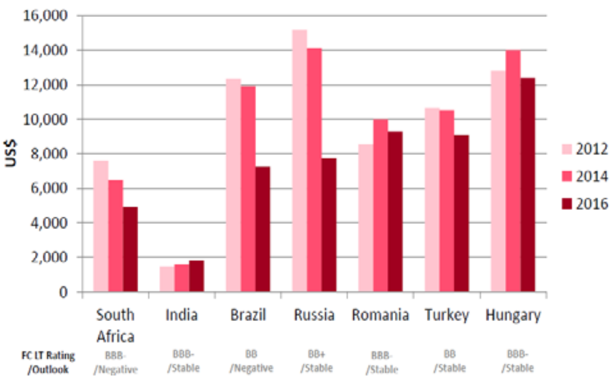


Source: National Treasury, Momentum Investments

Fitch addresses SA's low GDP per capita

Fitch highlighted that SA's real GDP per capita is estimated at US$5,140 in 2016, which ranks significantly lower than its peer group (US$9,188). The failure of SA growth to outperform population growth has been a key concern of S&P. In a recent presentation, S&P showed that SA's real GDP per capita had declined since 2012 and was markedly lower than many others in its peer group (see chart 3). While India's real GDP per capita ranks below that of SA's, India's growth profile has improved and it has experienced a significant turnaround in its external position.

Chart 3: Real GDP per capita peer comparison



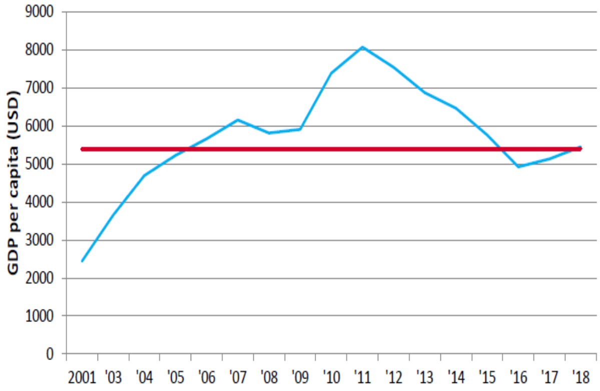
Source: S&P

Although the announcement of some progress on labour market reform may have bought SA some time with regards to S&P's rating decision on 2 December, Momentum Investments is still of the opinion that a downgrade to sub-investment grade status in June is more likely than not. S&P has emphasised that average living standards (measured by real GDP per capita) have dropped in SA, due to the low growth environment (see chart 4). For SA to maintain its current economic score on S&P's ranking, growth in real GDP per capita needs to improve from currently negative levels. Weak external demand, low commodity prices and challenges to domestic policy implementation driving down investment remain key risks to SA's potential growth profile. As such, Momentum Investments still views risks to SA's credit rating to the downside.

Fitch anticipates a marginal recovery in real GDP growth from an estimated 0.5% this year to 1.3% in 2017 and 2.1% in 2018, broadly in line with Treasury's estimates. Should these growth rates materialise, growth in SA's real GDP per capita would only just inch into positive territory in 2018.

Moody's warns that low levels of real GDP per capita will create pressures for social spending. Low growth further raises SA's chances of remaining in a middle-income trap, as its income gap with advanced economies widens further.

Chart 4: SA real GDP per capita over time

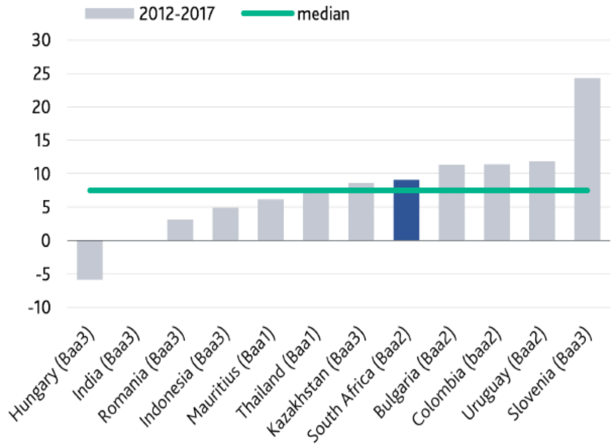


Source: S&P

SA's fiscal risks relative to peer group

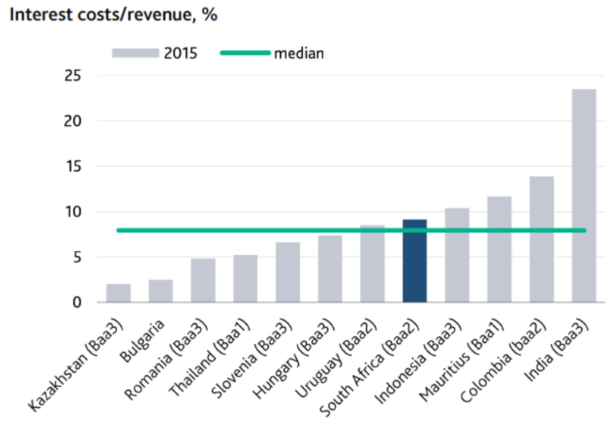
On Moody's ranking scale, SA's public debt ratio (relative to GDP), is marginally higher than its emerging market (EM) peers, while the pace of debt accumulation has also exceeded the peer median (see chart 5). An increasing debt burden has left SA's ratio of interest payments to revenue marginally in excess of the median (see chart 6). That said, Moody's suggests that a number of factors, including SA's low share of foreign debt, liquid domestic financial markets and high share of fixed-rate instruments (see table 2) reduces SA's risk of financing relative to other EMs of similar fiscal strength.

Chart 5: Debt accumulation marginally exceeds peers (% of GDP)



Source: Moody's

Chart 6: Debt servicing costs marginally exceeds peers

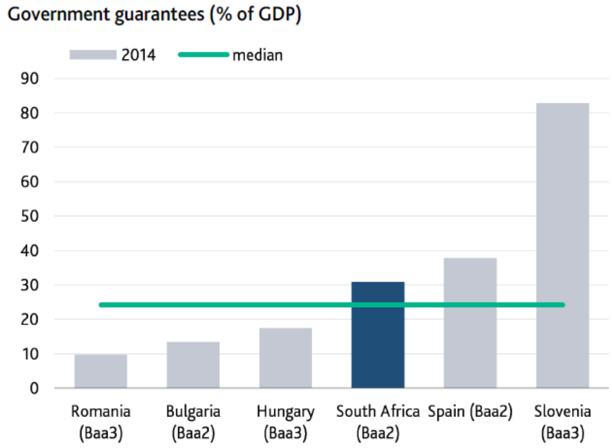


Source: Moody's

Table 2: Fiscal attributes and concerns as viewed by Fitch and Moody's

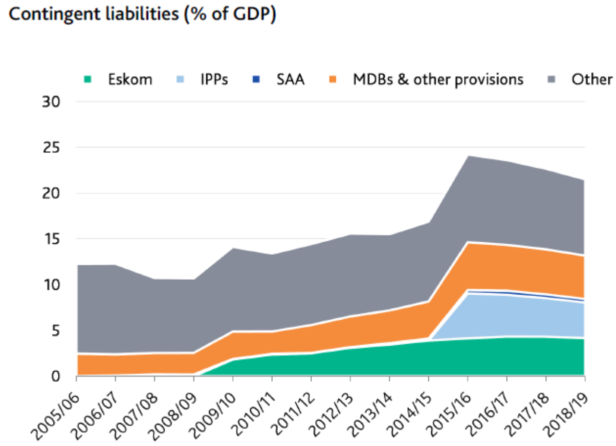
	Fitch review	Moody's review
Positive fiscal attributes	• Revised fiscal targets now look only mildly optimistic • Expenditure ceilings have never been breached • Government announced that the first nuclear plant will only be commissioned by 2037 ➔ alleviation of medium-term fiscal effect	• Government has prioritised pro-growth spending (infrastructure) • Primary surplus within reach • Debt portfolio benchmarks in line with global best practice • Low share of foreign debt • High share of fixed-rate instruments • Lower risk of refinancing relative to peers • Positive SoE developments regarding governance (new boards appointed at SA Post Office and SA Airways, Cabinet has approved new rules on appointing boards of directors)
Fiscal concerns	• Social pressures could lead to further spending needs (#FeesMustFall)	• Two bodies set up to improve state of SoEs (interministerial committee and a new council chaired by the President), but the responsibilities of each is unclear • Steady growth in SoE guarantees reflects delays in structural reform (see chart 7) • With Eskom mandated with the oversight of nuclear, guarantees could rise more rapidly • Risks to debt profile: - Lower-than-expected growth (if real GDP grew at 2.5% a year between 2012 and 2015, SA's debt ratio would have been 5% lower in 2015) - Spending pressures - Increase in interest costs - Contingent liabilities as a share of GDP is higher than similarly rated European peers (see chart 8) - Policy uncertainty - Public sector wage agreements (April 2018)

Chart 7: SA's government guarantees are significant



Source: Moody's

Chart 8: Government's explicit guarantees are growing



Source: Moody's

Government's response to Fitch and Moody's ratings reviews

In response to the Fitch and Moody's ratings reviews, National Treasury has suggested that efforts made by businesses, government, civil society, labour and politicians have paid off in keeping SA in investment grade. It notes the following as key areas of progress:

- Ensuring sustainable public finances
- Successful participation of independent power producers to alleviate the energy crisis
- Steps to attract private sector investment (easing regulatory burden, reducing the time spent on compliance, strengthening competition law and enhancing the environment for smaller enterprises)
- Cabinet has endorsed measures to improve governance in SoEs
- National minimum wage proposal
- Cabinet approval of the revised Integrated Energy Plan
- Fast-tracking micro reforms in tourism, agriculture and ocean economy

Treasury acknowledges the need to adhere to the expenditure ceiling, implement tax measures, spend infrastructure money efficiently, reduce waste and accelerate growth-enhancing reforms. Business is expected to play its role by helping to finance and mentor small businesses as well as assisting government and labour in tackling high unemployment.

Not out of the woods as yet

While Momentum Investments suspects continued growth in global economic activity, a reversal of the drought, increased domestic electricity supply and a greater resolve for faster fiscal consolidation may affirm SA's foreign rating by S&P on 2 December, S&P can send a strong signal to SA by lowering the two-notch gap that exists between SA's local and foreign ratings. Moreover, before triggering a move on the foreign rating, S&P may want to have more clarity around fiscal issues and wait for the February 2017 national budget, while further information about the state of finances and governance in SA's SoEs may arise in upcoming months.

Potential growth remains muted and real GDP per capita growth will likely struggle to outpace population growth in SA in the next three years. Low economic growth continues to constrain SA's economic assessment and rising political tensions are accentuating vulnerabilities. Consequently SA is, in Momentum Investments' view, not yet out of the woods regarding the foreign rating and, as such, the company sees a higher-than-ever chance of a foreign rating downgrade by S&P to sub-investment grade by June 2017.

Treasury has warned that a sub-investment grade status could translate into higher interest payments, a weaker rand, a higher cost of living, reduced fiscal space to address escalating spending pressures and subdued confidence ultimately translating into low investment and weak job creation. Unlike the unfavourable fiscal response triggered in Brazil following a rating downgrade to junk, which led to a downgrade spiral, Momentum Investments expects a downgrade of the foreign rating into junk status to be treated with caution in SA. Government is likely to adhere to fiscal consolidation and trigger much-needed structural reforms to reverse the negative rating within the next five-year horizon.

For SA to lose its spot in indices such as the Citi World Government Bond Index, the long-term domestic currency rating would need to be lowered into sub-investment grade by Moody's and S&P. As such, Momentum Investments does not view this as an immediate concern for SA. Even with an expected one-notch downgrade in the local currency rating by S&P, the local currency rating would still be two notches away from sub-investment grade on Moody's and S&P's rankings.