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The Macro Research Desk

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Fiscal discipline closely monitored amid low growth and noisy politics

Moody's concludes its review on South Africa (SA) by lowering the foreign and local currency ratings by one notch

Following an announcement by Moody's on 4 April 2017 to place SA on review for downgrade, the rating agency finally delivered its judgement after market close on 9 June 2017. Moody's decision to lower the country's foreign and local currency ratings from Baa2 to Baa3 (negative outlook maintained) was in line with concerns raised by Fitch and Standard & Poor's Global Ratings (S&P) in their latest assessments. Although Fitch and S&P left SA's foreign and local currency ratings (and outlook) intact in their latest reviews scheduled earlier this month, which followed negative ratings action taken in April 2017. At its April review, Fitch lowered SA's foreign and local currency ratings to sub-investment grade and placed SA on a stable outlook. S&P maintained the one-notch gap between the foreign and local ratings, but downgraded both ratings by one-notch, to BB+ (sub-investment grade) and BBB- (lowest investment grade rung), respectively, while keeping the outlook on SA's ratings on negative (see table 1).

Table 1: Comparative ratings between the three key ratings agencies

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
Outlook	Negative	Stable	Negative

Local currency rating
Foreign currency rating

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

Elevated political risks undermining economic progress are a common concern across the key rating agencies

All three rating agencies have warned that noisy politics in SA is suppressing confidence and trapping SA in a low growth environment. A further dip in trend growth or a marked increase in government debt or contingent liabilities are seen as common triggers for additional negative ratings action, while an improvement in SA's business climate or better-than-expected fiscal or growth outcomes could lead to a more favourable ratings outcome (see table 2).

Table 2: June 2017 ratings review comparison between Fitch, S&P and Moody's

	Fitch	S&P	Moody's
Outcome	• **Sovereign:** Stable at BB+ • **Local:** Stable at BB+ • **Outlook:** Remains stable	• **Sovereign:** Stable at BB+ • **Local:** Stable at BBB- • **Outlook:** Negative outlook maintained	• **Sovereign:** Downgraded one notch to Baa3 • **Local:** Downgraded one notch to Baa3 • **Outlook:** Negative outlook maintained
Reasons behind the outcome	• Cabinet reshuffle has undermined governance efforts at state-owned enterprises ➔ risk of rising contingent liabilities • Weak business confidence ➔ low growth environment ➔ threat of revenue underperformance • SA's five-year GDP growth average of 1.6% is significantly weaker than the BB category median of 3.5% • SA's general government debt ratio relative to GDP at 52.6% is higher than the BB median of 51% and higher than the BBB median of 41%	• Elevated political risks • Pace of economic growth remains weak ➔ risks to fiscal consolidation • Rising contingent liabilities (currently viewed as 'moderate') • Inability to reduce inequality in the medium term	• Evidence of systemic weakening of the institutional framework • Policy uncertainty and slower progress on structural reform ➔ reduced growth prospects • Erosion of fiscal strength ➔ rising public debt and contingent liabilities
Triggers for potential negative ratings action	• Marked increase in government debt-to-GDP ratio • Marked increase in contingent liabilities • Sustained uncertainty ➔ deterioration in trend growth • Rising net external debt levels • Relaunch of nuclear consultations, which could raise government's exposures significantly	• Political risks have a larger effect on sentiment • Deterioration in fiscal (deficit expected to narrow from 3.4% in 2017 to 2.7% in 2020) and growth (1.0% expected in 2017 increasing to 2.0% in 2020) performance	• Diminishing strength and independence of the country's institutions • Less predictable policy framework • Further delays in structural reforms • Increased liquidity pressures at state-owned enterprises
Triggers for potential positive ratings action	• Strengthening in trend growth • Improvement in governance ➔ improvement in business climate and public finances • Marked narrowing in budget deficit and reduction in debt ratio	• Reduction in political risks • Fiscal and growth outcomes better than projected	• Strong policy-making capabilities • Continued independence of key policy institutions • Enhanced medium-term growth prospects • Decline in guarantees to the state-owned enterprises

Source: Fitch, Moody's, S&P

Sizeable contingent liabilities, deteriorating governance and a disadvantageous business climate weigh down the rating

Although noting a number of positive fiscal attributes (see table 3), the three rating agencies have raised risks to SA's current ratings outlook. While not their central view, the rating agencies have flagged the risk that high levels of social inequality and fractious politics could tilt government towards more populist and interventionist policies, risking fiscal slippage and a further deterioration in SA's government debt profile.

Table 3: Fiscal attributes and risks as viewed by three key rating agencies

	Fitch	S&P	Moody's
Positive attributes	• Deep local capital markets • Favourable government debt structure • Prudent fiscal and monetary policy (historically) • Fully flexible exchange rate • SA's GDP per capita (US$5 246) in line with BB median (US$5 058) • SA's World Bank governance indicator is well above the BB median (but recent events may have affected SA's ranking) • Sound banking system	• Monetary flexibility • Improving external position • Strong democracy • Independent media • Independent judiciary • Floating exchange rate regime	• Deep domestic financial markets • Well-capitalised banking sector • Well-developed macroeconomic framework • Low foreign currency debt • Rule of law maintained
Risks	• Financial state of state-owned enterprises worsens • Nuclear energy could raise government's exposures • Radical policy changes to address inequality and unpredictable policy	• Policy agenda at risk of being overshadowed by political infighting • Risk of unpredictable policy responses • Potential for high inequality to drive policy towards intervention • Additional funding requests for new policy priorities • Non-resident holdings in government bonds vulnerable to foreign investor sentiment, exchange rate fluctuations and a rise in developed market interest rates • Governance issues overshadowing plans to improve Eskom's financial position ➔ risk to contingent liabilities	• Downside risks to growth ➔ threat to fiscal consolidation • Uncertain political developments ➔ could hamper prospects for structural reform • Contingent liabilities are a risk to the country's fiscal strength

Source: Fitch, Moody's, S&P

Government's response to the ratings reviews

In response to the rating agencies' reviews, Treasury reiterated that its fiscal policy stance continues to be guided by chapter 13 of the Constitution, which states that "while there is promotion of efforts aimed at economic development, good governance, social progress and a rising standard of living for all South Africans, there must also be transparency, accountability and sound financial controls in the management of public finances". Treasury, in conjunction with broader stakeholders, remains committed to tackling the country's low growth challenge (the National Development Plan remains the cornerstone of economic policy in SA) and addressing subdued confidence, through improving policy design, finalising key policies and re-engaging with the private sector. Treasury recognises the need for fast-tracking collaboration with business, labour and civil society to improve investor and consumer confidence, highlighting this as an urgent priority in its efforts to reclaim the country's investment grade ratings.

In addressing the financial challenges and poor governance at state-owned enterprises, government has:

- Endorsed a private-sector participation framework to guide collaboration with the private sector on infrastructure projects
- Adopted a guideline for remuneration/incentive standards for directors
- Approved a guide on appointments of boards
- Recommended additional consultation on the first version of the new government shareholder policy

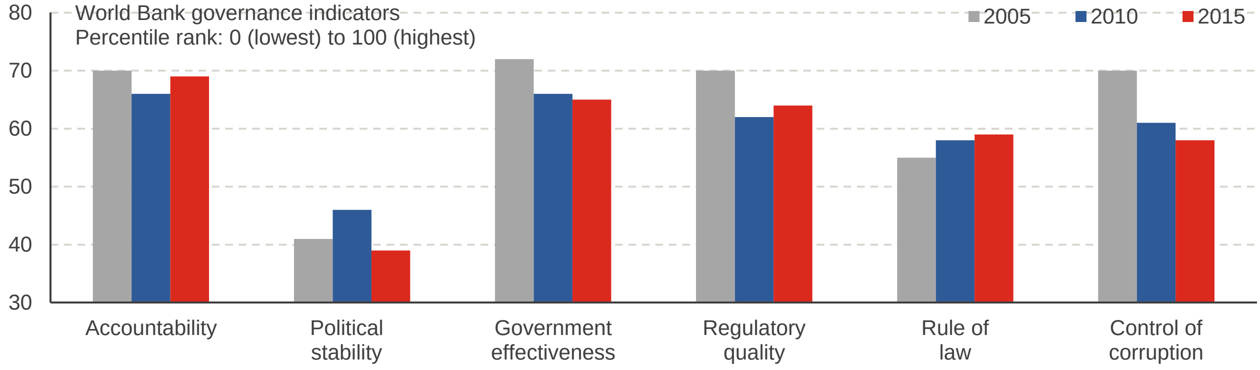
Treasury has also responded to the corruption allegations stating that "the Constitution remains explicit in realising the fundamental rights of all who live in SA and that the public funds are spent for a common good". It also clarified (as Fitch pointed out in its review) that "radical economic transformation does not imply a fundamental policy shift" and the focus of government remains on inclusive growth.

Where does SA's sovereign ratings outlook stand?

Though the rating agencies expect SA's growth recovery to be more gradual than Treasury's estimates outlined in the February 2017 national budget, a disappointing first-quarter-growth contraction poses additional risks to the outlook for economic activity for the year. A lower growth outlook necessitates a strict adherence to government's self-imposed expenditure ceiling and may require a tough stance on next year's multi-year wage agreement in the public sector and additional cuts in non-essential goods and services to achieve Treasury's commitment to fiscal and debt targets. S&P's projections for the net debt-to-GDP ratio allow for some wiggle room. S&P forecasts net government debt to stabilise at 50% of GDP by 2019, whereas Treasury projects a peak of 48%.

The rating agencies voiced their concerns that heightened political tensions could undermine efforts to improve governance at SA's ailing state-owned enterprises. Weak balance sheets at these institutions pose a key threat to the country's overall debt levels. The International Monetary Fund has in addition noted concerns over SA's high level of contingent liabilities among state-owned enterprises and the level of efficiency at these firms, which increases overall costs.

Chart 1: SA has been slipping on the World Bank's governance indicators



Source: World Bank, Momentum Investments

In Momentum Investments' opinion, the ratings outlook for SA remains dependent on government's willingness and ability to rebuild the integrity of the state and key organs of the state. Despite SA being graded higher than some of its emerging market peers (including Turkey, Brazil and Russia) on the World Bank governance indicator, SA has lost ground relative to its own history on a number of critical underlying indicators of governance, including political stability, government effectiveness and control of corruption (see chart 1). SA's ability to arrest the decline in governance, poor procurement practices and operational inefficiencies at key state-owned enterprises, limit policy confusion and create conditions for further investment could restore a higher level of potential growth in the medium term.

A commitment to generating inclusive growth and bolstering social cohesion will address rising socio-economic pressures and limit harmful populist and interventionist policies, in turn preventing a sticky budget deficit and capping overall levels of public debt. Maintaining the independence and strength of key institutions (namely the judiciary, the Reserve Bank and Treasury) is equally as important. In its latest June 2017 review, Moody's highlighted the need for a transparent, effective and predictable institutional framework to create a predictable policy environment.

Moody's admitted that the opposite scenario has a higher likelihood of materialising, as reflected in its negative outlook on the sovereign rating. This scenario addresses the failure to develop a political consensus to support investment and reform efforts, resulting in heightened political dysfunction and continued gradual institutional weakening and reduced clarity over policy objectives.

With Fitch maintaining its outlook on stable, the risk of a further downgrade at the end of the year is likely limited. Similarly, S&P and Moody's may wait to determine whether the new leadership of the ruling party (to be elected at the African National Congress National Elective Conference in December 2017) is committed to accelerating structural reforms, curbing corruption and restoring trust with the private sector. The rating agencies may also choose to wait until after the February 2018 national budget to assess the performance of the new leadership at Treasury and whether it has been successful in toeing the fiscal line and preventing an escalation in the deterioration in the finances and governance at SA's key state-owned enterprises.

SA's sovereign credit rating is critical in ensuring SA's inclusion in a number of global bond indices. Losing the country's position in the Citi World Government Bond Index (WGBI) poses a threat to the currency. The potential foreign capital outflow associated with SA bonds dropping out of the WGBI has been estimated between R80 billion and R130 billion. Falling out of the WGBI requires SA's local currency rating by S&P as well as Moody's (currently ranking at the lowest investment grade rung) to deteriorate to sub-investment grade. Following the recent ratings moves, Momentum Investments acknowledges the increasing risk of SA bonds dropping out of the WGBI in the next twelve months. Exclusion from the WGBI could have a longer-lasting effect on foreign flows into SA. Citi has warned should the exclusion be triggered, the criteria to be re-included are reasonably onerous, including a four notch ratings upgrade, which could take several years to achieve.