South Africa Credit Ratings

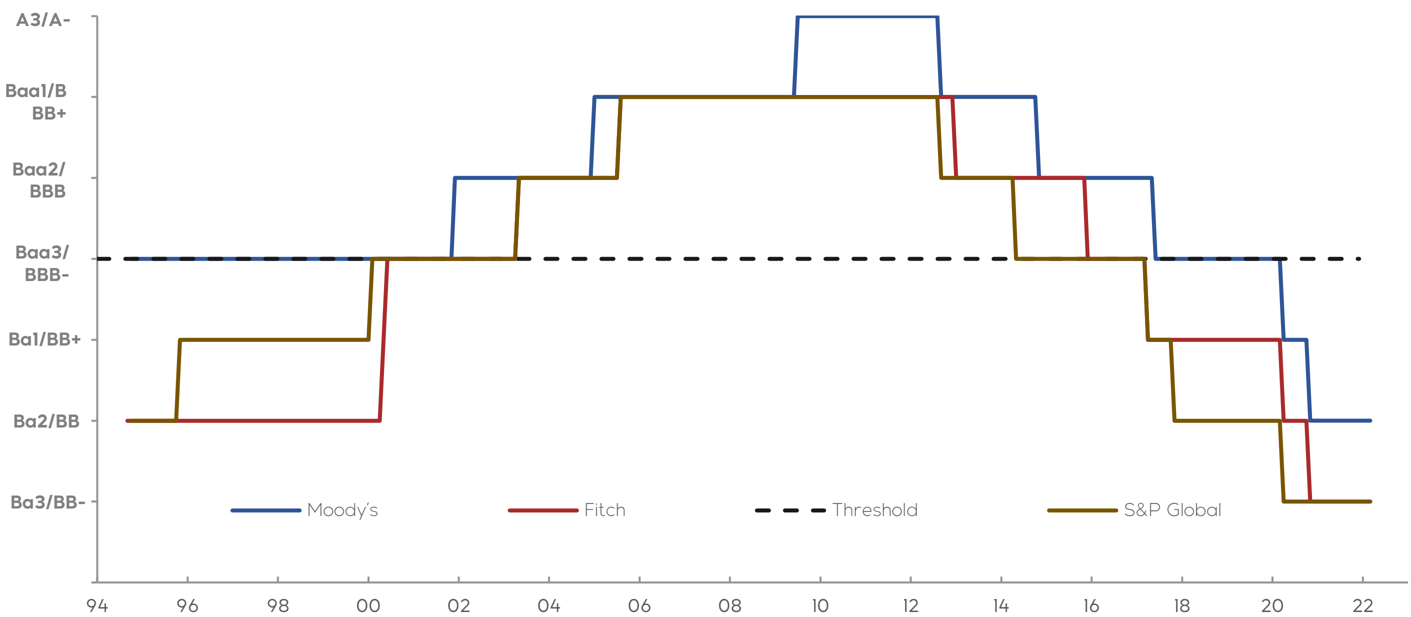
ECONOMICS | SOUTH AFRICA

NEDBANK

No credit rating upgrades yet as the critical ratios remain high

- **Moody's Investor Services** (Ba2, negative outlook) and **S&P Global Ratings** (BB-, stable outlook) will release their credit rating reviews on 1 April and 20 May, respectively. **Fitch Ratings** (BB-, stable outlook) does not provide its release dates as its analysts are based outside the European Union, but its review is due around the same time. The agencies assess several factors that currently point to the current ratings being maintained.
- **Macroeconomic reforms:** Recently announced policies aimed at boosting investment and economic growth are encouraging, but the pace of reform is still slow. Successful bidders for new renewable energy generation under bid window 5 of the Renewable Energy Independent Power Producer Programme (REIPPP) have been licensed. Bid window 6 will be finalised in 2022. The limit for embedded power generation has been raised to 100 MW, while the IPPs will be licensed to directly supply power to the national grid. Transnet will license private rail operators to utilise the national rail network. At the same time, the establishment of Transnet National Ports Authority as a separate entity aims to improve the management of national ports, with a particular focus on the strategically important Durban port. At the same time, the release of more internet bandwidth has been concluded, although the outcome could be overturned by a court challenge by one of the successful bidders. The recent investment conference, a sequel to the ones held before the pandemic disrupted the economic mood, secured more significant investment pledges. However, the rollout of the investments and their impact on the economy will take some years to materialise. The corporate tax rate reduction to 27% from 28% was a positive move, but it needs to be coupled with more significant measures. Overall, the reform measures are encouraging, but broader steps to unlock bottlenecks and improve efficiency in the network industries need to be implemented.
- **Economic growth**: The local economy was buoyed by the favourable global environment in 2021, benefitting from global demand and high commodity prices. Domestic demand growth was relatively subdued, with several once-off and persistent factors disrupting its momentum. Although most operations were quickly restored, the July riots and looting negatively impacted local supply chains. Significant power shortages have proven to be a longer-lasting hindrance to the local recovery. We expect economic growth to ease from 4.9% in 2021 to 2.2% in 2022 and to average 1.6% per annum between 2022 and 2025, with the risks to domestic growth remaining to the downside. Fitch Ratings estimates the average growth rate of BB-rated sovereigns at 4%[1] per annum between 2021 and 2023.

Chart 1: Long-term foreign currency ratings



Source: Rating agencies

[1] The three-year average centred on the middle year, as calculated by Fitch Ratings in January 2022

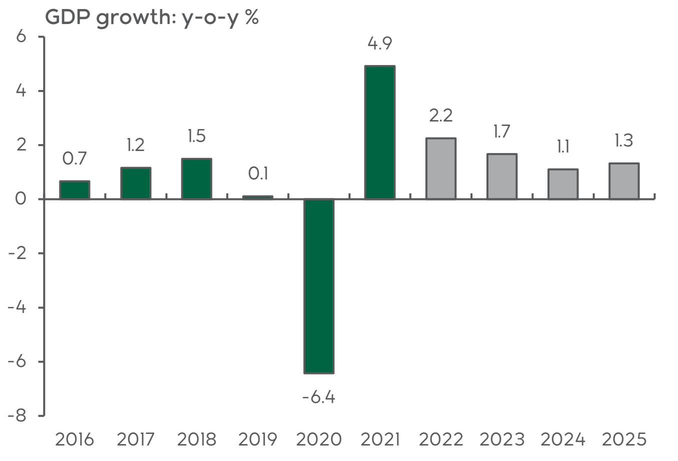
- **The fiscal position:** The government remains committed to reducing the budget deficit and containing the growth in the public debt stock. Stronger economic growth and higher-than-previously projected revenue collections help to improve the fiscal ratios over the Medium-Term Expenditure Framework period (MTEF – 2022/23 to 2024/25). However, expenditure targets are likely to be missed, with the wage bill, debt service costs, and higher social spending the main functions that will likely push aggregate expenditure above the current targets.
- **The budget deficit:** The deficit will narrow slowly and stay well above the BB median of 2.8%[1]. Financing the deficit will not be a significant challenge due to the deep local capital markets and the sovereign's access to global capital markets. However, the ratio of local currency government bonds held by international investors has dropped sharply to below 25%, which indicates a narrower investor base. This suggests that if local and global financial markets deteriorate significantly, as in 2020, rollover risk and borrowing costs will increase.
- **Public sector wage bill:** The 2022 Budget set the growth of the wage bill at 1.8% a year between 2022/2023 and 2024/25. The Constitutional Court judgement ratified the 2020 wage freeze, which saved R38 billion, but the ruling in favour of the government resulted from a legal technicality that the labour unions will avoid in the current negotiations. The unions have adopted a hard-line stance in the current wage negotiations, demanding wage increases of up to two percentage points more than the inflation rate. However, the settlement is unlikely to be significantly higher than the inflation rate. We assume wage increases averaging 4% a year over the MTEF period, which would push the wage bill to R44 billion or 2.1% more than the MTEF target. National Treasury stressed that in the event of higher-than-budgeted wage increases, wage bill consolidation would be achieved by reducing staff numbers.
- **Debt service costs:** The elevated public debt stock will increase interest payments by 12.2% to R310.8 billion in 2022/23. Over the MTEF, growth in interest payments averages 10.4% per year, pushing debt service costs to 20.6% of gross tax revenue by 2024/25 from 19.4% in 2022/23. Rising interest rates will add to the debt service bill, keeping it well above the BB-rated median of 8.9%[1].
- **Social grants:** The government has extended the Social Relief for Distress (SRD) grant to March 2023, costing R44.4 billion in 2022/23. We believe that the government will implement some form of a basic income grant once the SRD programme expires, adding about R45 billion a year to aggregate expenditure over the MTEF.
- **Public debt:** The narrower budget deficit helps contain the debt-to-GDP ratio's growth over the MTEF. The National Treasury projects the ratio to ease to 69.5% in 2021/2022 before rising steadily to peak at 75.1% in 2024/25 and to ease to 70.2% in 2029/30. Therefore, the level of public debt will remain above the pre-Covid peak of 63.3% in 2019/20 and the BB-rated median of 39.5% in 2021. A credit-positive factor is the low ratio of external public debt at an average of 11.3% of total public debt, versus the BB-rated median of 60.7%[1].

Conclusion

The National Treasury continues to demonstrate its commitment to stabilise public finances, which deteriorated dramatically over the past decade. However, much of its success will depend on the growth trajectory and the government's ability to exercise expenditure restraint. The government will need to limit growth in non-investment, albeit critical functions, while accelerating and improving the efficiency of spending on investment projects. This, coupled with more policies to unlock the growth bottlenecks in the network industries, will boost the growth rate and the economy's capacity to create jobs. The government has little room to maneuvre on debt service costs, and the pace of fiscal consolidation will depend on containing the public sector wage bill and boosting economic growth.

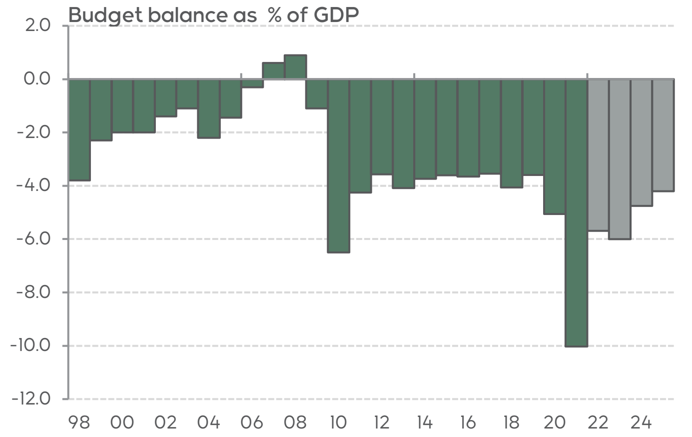
The revised fiscal ratios will help avoid further credit rating downgrades instead of improving the chances of an upgrade in the foreseeable future. Even with the lower figures, South Africa's ratios remain well above the medians of BB-rated sovereigns. As such, we expect S&P Global and Fitch to affirm their credit ratings and maintain a stable outlook, and Moody's to affirm its rating but revise the outlook to stable from negative.

Chart 2: Real GDP growth to ease in 2022



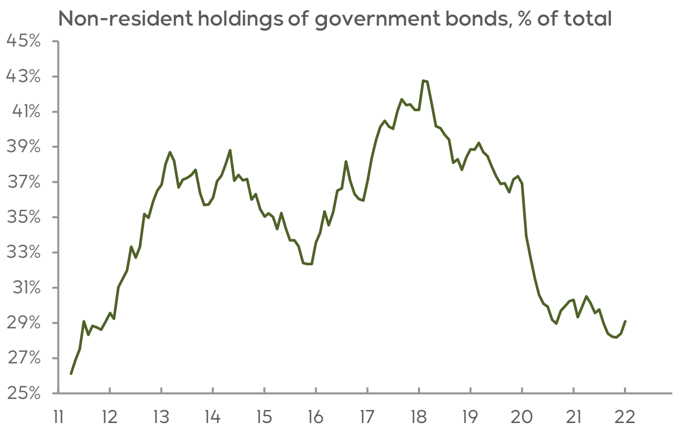
Source: Nedbank Group Economic Unit

Chart 3: The budget deficit will narrow slowly over the MTEF



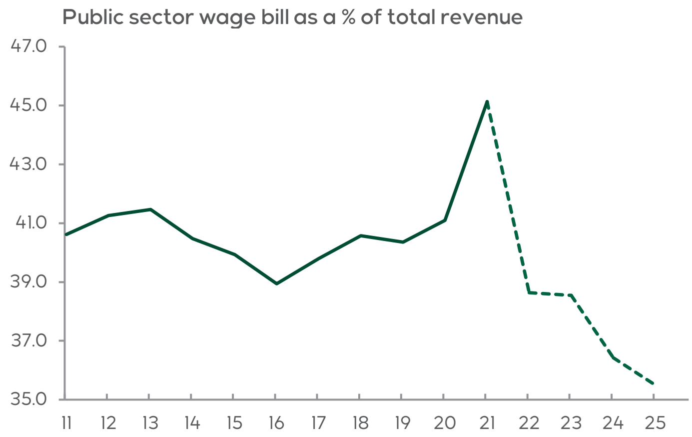
Source: National Treasury Budget 2022

Chart 4: Foreign investors have reduced their holdings of local bonds



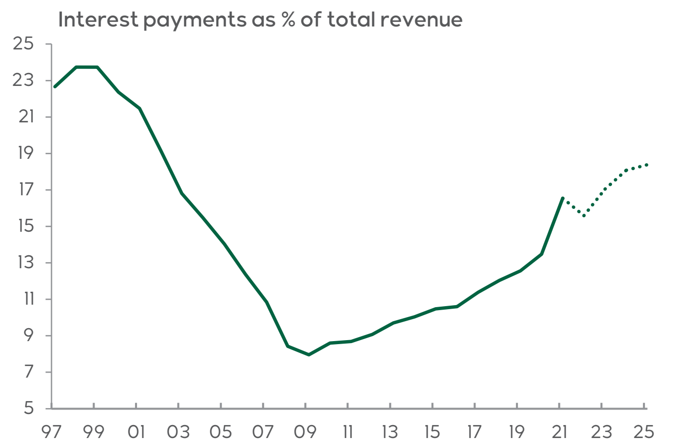
Source: National Treasury

Chart 5: The wage bill to be contained



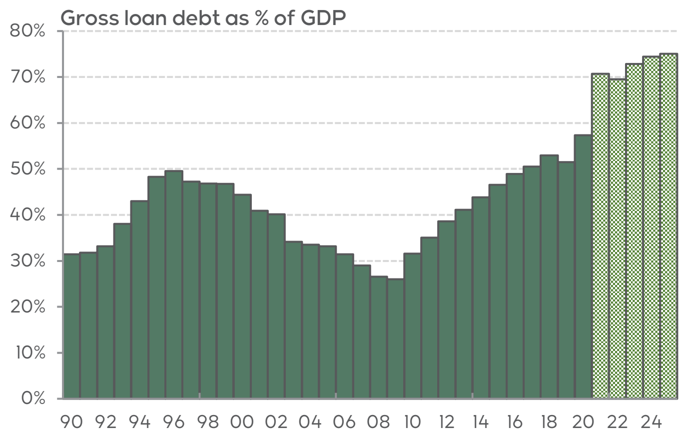
Source: National Treasury Budget 2022

Chart 6: Debt service costs are absorbing more of fiscal revenue



Source: National Treasury Budget 2022

Chart 7: The public debt ratio is set to increase further



Source: National Treasury Budget 2022

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