05 May 2021

South Africa Credit Ratings

Economics | South Africa

Prospects of further rating downgrades remain high

- **Moody's Investor Services** (Ba2, negative outlook) and **S&P Global Ratings** (BB-, stable outlook) will release their rating reviews on 7 May and 21 May, respectively. **Fitch Ratings** (BB-, negative outlook) does not provide its release dates as its analyst is based outside the European Union, but its review is due at about the same time (chart 1).
- The three agencies adopted cautious responses to this year's budget, warning that the National Treasury set a challenging fiscal roadmap. The budget deficit and public debt targets are based primarily on an economic rebound and containing the public sector wage bill. Both these drivers face significant downside risks.
- The rating agencies have cited the independence and credibility of the South African Reserve Bank, exchange rate flexibility and deep local capital markets as credit-positive factors. In addition, the notable improvement of the current account and a low level of external debt support the current ratings. However, key factors that underpinned the rating downgrades into sub-investment grade are still unfavourable.
- **Economic growth**: Growth was already anaemic heading into 2020 (the economic downturn started in December 2013). Real GDP growth slowed to 0.2% in 2019, averaging only 0.8% since 2015. GDP per capita contracted by a 2.3% annual average since 2015, and the official unemployment rate rose to more than 30%. The outlook for growth remains lacklustre even from the low base set in 2020. The 2020 contraction of 7% was slightly shallower than the market consensus of -7.3% at the time of the November 2020 rating reviews, but forecasts for the next two years have trended broadly sideways (chart 2). The implementation of growth-enhancing measures remains almost non-existent, and the economy is forecasted to return to its pre-Covid level only in 2023. This points to the socio-economic situation not improving rapidly − a rating-negative factor.
- **Fiscal budget**: Preliminary figures indicate that 2020/21 revenue collections were R37.8 billion more than forecast in Budget 2021 but R175.4 billion (12.3%) short of the original budget estimates (Table 1). This, against the backdrop of a slightly shallower 2020 contraction, points to a marginally narrower 2020/21 deficit (chart 3). The latest economic data suggest an economic rebound firmer than National Treasury and the market consensus forecasts. However, the deficit will remain wide and further raise the public debt stock over the next three years. Subdued revenue growth will place an even more significant burden on expenditure cuts to narrow the budget shortfall.
- **Public sector wage bill:** Expenditure reduction is anchored on containing the public sector wage bill over the next three fiscal years (chart 4). The government plans to increase the wage bill by an average of only 1.2% per year over 2021/22 to 2023/2024, while the 2020/21 wage freeze is still subject to a Constitutional Court judgement. Public sector unions entered the wage talks with a demand of CPI plus 4%, which has resulted in a deadlock. Based on the 2020/21 public sector wage bill of R574.4 billion, meeting the unions' demands will add R274.3 billion (15.6%) to the envisaged wage bill over 2021/22 to 2023/2024, assuming a steady public sector workforce and a 4.5% annual CPI rate. If the Constitutional Court rules in favour of the unions, R37 billion will be added to the 2020/21 wage bill. Additionally, Eskom has started wage talks with unions demanding a 15% per year hike for three years. If granted, although this is highly unlikely, the high wage increases will exert further fiscal pressure in the form of higher bailouts for the financially constrained electricity utility.

Table 1: Revenue estimates and preliminary outcome for 2020/21

R billion	2019/20 actual	Budget 2020	Supp. Budget 2020**	MTBPS 2020***	Budget 2021	Preliminary outcome
	1 355.8	1 425.4	1 121.3	1 112.6	1 212.2	1 250.0
Diff*. vs 2019/20 actual		69.7	-234.4	-243.2	-143.6	-105.8
Diff*. vs Budget 2020			-304.1	-312.8	-213.2	-175.4
Diff*. vs Supp. Budget 2020				-8.7	90.9	128.7
Diff*. vs MTBPS 2020					99.6	137.4
Diff*. vs. Budget 2021						37.8

Source: South African Revenue Service; *Difference, **Supplementary Budget, ***Medium-Term Budget Policy Statement

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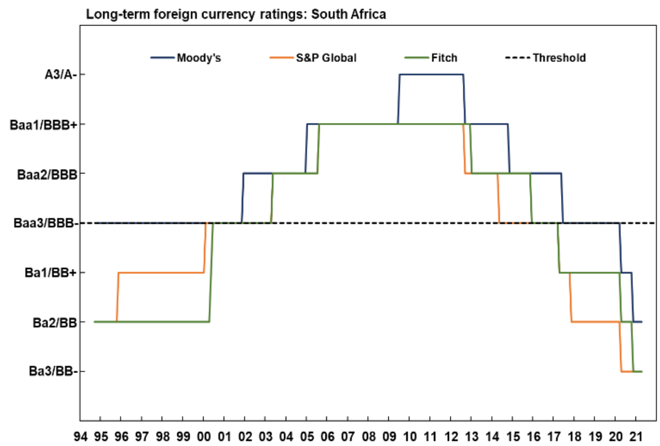
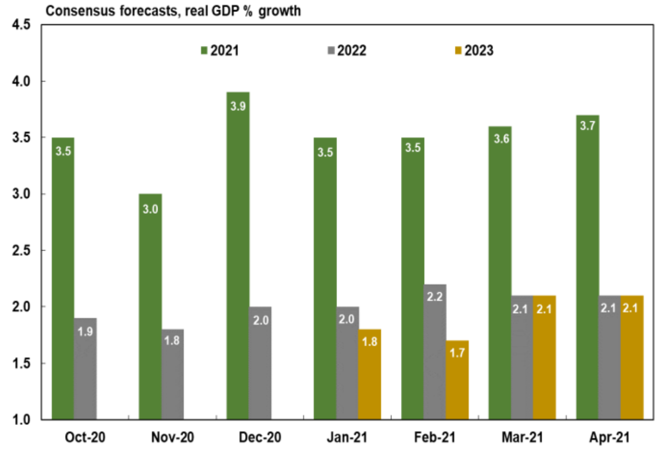
- **Fiscal financing:** The budget shortfall has historically been financed via the issuance of long-term local-currency bonds. However, National Treasury will increase its foreign-currency borrowing over the three years to 2023/24. The public sector borrowing requirement will hover around an elevated 10% of GDP per year over 2021/22 to 2023/24, which could pose financing challenges if global market conditions worsen again. In March 2020, the South African Reserve Bank intervened in the secondary bond market to ease liquidity pressures. Bond market liquidity has since normalised, and the Reserve Bank has started to reduce its holdings of government bonds. However, the proportion of bonds held by foreign portfolio investors is still close to recent lows, suggesting that the breadth of external funding for the sovereign has shrunk (chart 5).
- **Debt-to-GDP ratio:** The trajectory of the public debt ratio presented in Budget 2021 is lower than in the October 2020 Medium Term Budget Policy Statement (MTBPS). National Treasury projects the ratio to peak at 88.9% in 2025/26 and gradually ease to 86% in 2028/29, which compares favourably with a peak of 95.3% projected in the MTBPS. However, the ratio remains well above the median of BB-rated sovereigns, which Fitch Ratings calculated at 50% in 2020.
- **Debt service cost ratio:** The rapid increase of the public debt stock has raised interest payments significantly. The interest bill rose by 13.7% in 2020/21, and National Treasury projects it to increase by an average of 13.3% per annum over 2020/21 to 22023/23. As such, by 2024 the ratio will breach 21%, with interest payments absorbing 21c of every R1 of revenue collected at the national level. Debt service cost-to-GDP will breach 5% (chart 6).
- **Conclusion:** The balance of factors points to imminent rating downgrades deeper into sub-investment grade. However, the rating agencies are likely to hold off until the public sector and Eskom wage talks have been finalised. S&P Global Ratings and Fitch Ratings will be reluctant to move a country with reasonably solid institutional governance and deep local financial markets below the psychological hurdle of a B rating. This hesitancy is likely to delay further downgrades for at least a year. Moody's and Fitch Ratings downgraded their ratings in November 2020, which may persuade them to adopt a 'wait-and-see' at least until the 2022 budget. However, a deterioration of economic prospects would increase the chances of further downgrades during this year.
- To improve the country's ratings, the government must tackle the longstanding macroeconomic challenges head-on. First, stabilise government finances. Second, restore the state-owned enterprises to good financial health. This will reduce the burden on the fiscus and the risks posed by the high contingent liabilities. Third, eradicate power shortages by stabilising Eskom and prioritising the licensing of renewable power projects. These three steps will lift confidence, facilitate greater fixed investment by the private sector and ultimately stimulate job creation.

Chart 1: SA ratings well in sub-investment grade



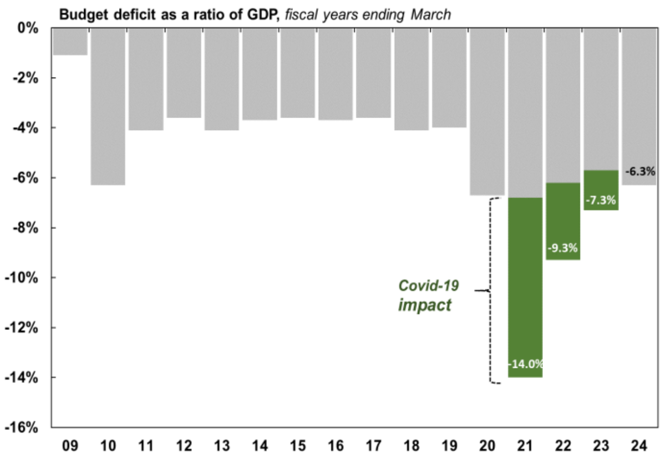
Sources: Moody's Investor Services, S&P Global Ratings & Fitch Ratings

Chart 2: Growth expectations are moderate



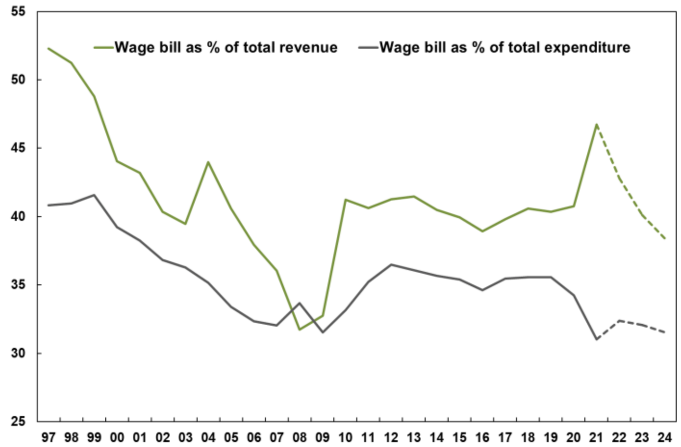
Source: Reuters *Econometer*

Chart 3: Budget deficit reduction will be slow



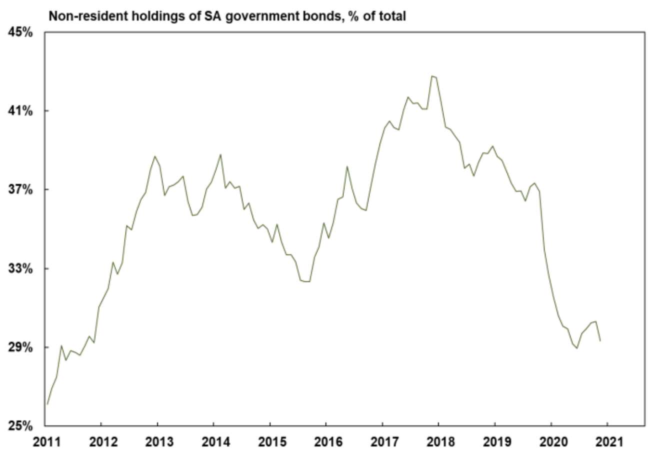
Source: National Treasury South Africa

Chart 4: An unsustainably high public sector wage bill



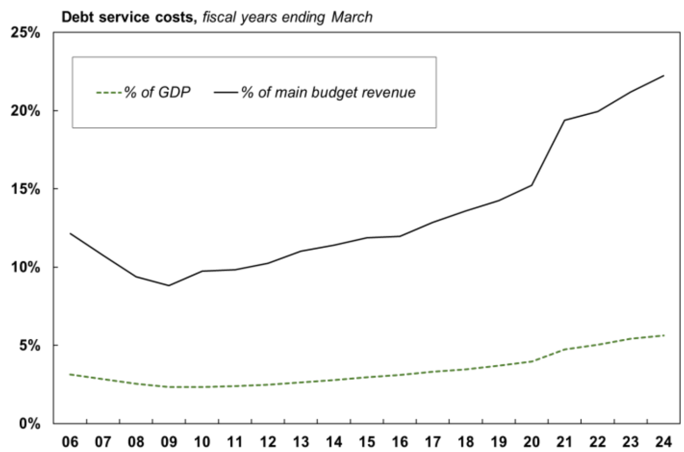
Sources: National Treasury South Africa, forecasts from 2021

Chart 5: Foreign bondholders have lower SA exposure



Source: National Treasury South Africa

Chart 6: A high debt service ratio



Sources: National Treasury South Africa

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