MOODY'S DOWNGRADES SOUTH AFRICA'S CREDIT RATING TO 'BA1'; OUTLOOK REMAINS NEGATIVE

Moody's expects debt to continue rising amid a structurally very weak growth environment; economic and fiscal policy responses may be ineffective in addressing this

- On 24 March 2020, Moody's sovereign committee convened to review the South African government's rating
- The outcome was a one-notch downgrade of the sovereign's rating from "Baa3" to "Ba1", with the outlook remaining Negative
- The Negative outlook horizon (12-18 months for sub-investment grade) reflects the risk that economic and fiscal metrics could deteriorate further, driven by policies being ineffective in containing the impact of the global recession on the South African economy and reform inertia further entrenching negative domestic economic sentiment
- This could further lower debt affordability and potentially weaken the government's current strong access to funding
- The government's ability to mitigate the above risks is currently limited, as the fiscus is already under strong and widespread pressure, while monetary policy cannot address underlying structural economic issues
- The decision to downgrade the credit rating was in response to the government's constrained capacity to stimulate the economy in a period of low global and domestic growth, coupled with an unavoidable further rise in debt over the medium term at a pace faster than Moody's had expected
- The rating transition was driven by a downward revision in the economic score by one notch from "baa2" to "baa3" (in line with our expectations) and the fiscal score by three notches from "ba1" to "b1" (worse by one notch than we had initially expected)
- While the institutional and governance, and susceptibility to event risk scores have remained unchanged, Moody's highlights some deterioration in both metrics
- In our view, the risk that South Africa will be downgraded further down sub-investment grade remains, as domestic politics are still unlikely to create sufficient space for the sovereign to correct credit weakness and the full negative economic impact of COVID-19 is also uncertain

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Discussion box – Comments and FAQs

Is this rating action "one and done" for this year? We think not. It often happens that sovereign transitions into sub-investment grade go beyond one notch in a short space of time. [Case in point: S&P's rating (BB/Negative) has shifted two notches in a relatively short period of time, and Fitch's is on the brink of another downgrade at BB+/Negative currently.]

Moody's Negative outlook points to an (at least) one-in-three chance of a downgrade within the next 12-18 months. We see the November review (post the 2020 MTBPS) as the next credit event and we think the likelihood of a downgrade is much higher than one-in-three. We will be revising our view as we see how the COVID-19 crisis is managed from a fiscal point of view and then a growth stimulus and recovery perspective.

Talk of regaining investment grade, at Moody's, in a short space of time is not realistic. With a Negative outlook in place, the best South Africa can do is take mitigating actions to stabilise the rating at current levels. These actions are the same as what would have been needed to stabilise the rating one notch higher at "Baa3" and retain investment grade. These include fiscal consolidation, a balanced primary deficit that stabilises the debt burden below 90% of GDP, and structural reforms that can inspire a modest recovery in growth and buoy tax collection in order to balance the budget.

The drivers of a further downgrade to "Ba2" hinge upon the following:

- Continued stagnation in economic growth. Currently, Moody's sees a -2.5% contraction this year and then a recovery from a low base of 1.1% in the following year. So, if the contraction is deeper, or the recovery is weaker for longer, we could see a downgrade.
- Primary deficit widens further (even gradually). Moody's sees the primary balance/GDP ratio peaking at -4.0% in 2020/21 and then gradually reducing towards balance or to around 0%. If the trend reverses or the gap remains wide at around -1.0% or less, it would imply that debt stabilisation is failing and the National Treasury is losing fiscal control, and the borrowing requirement continues to steepen the curve and cost of debt.

What is new in Moody's review of SA this time? First, we see (with a little more clarity) how Moody's has formed its scores and opinions on South Africa, using its updated methodology.

More substantively, **Moody's has lowered its view on Banking Sector Credit Events (BSCEs)** to the sovereign. It is now the weakest link (alongside domestic political risk) in the "susceptibility to event risk" component – this is an adjustment to its view of the government's financial credit strength.

Traditionally, South African banks have been viewed as stable, profitable, well capitalised and producing low credit losses through cycles. However, we think Moody's has been spooked by the lower-return profile, recently reported, and the expected credit losses that will be charged through the banking book because of the deep contraction in growth. The banking system's risk management framework will now be tested, but we think it remains robust.

We do not think that Moody's will take temporary prudential measures into consideration (including the relaxation of IFRS 9 and classification of restructured loans during the COVID-19 period and the relaxation of minimum capital requirements and LCR ratios among other capital accounting measures), but that it is concerned about how the banking sector's risk profile may emerge out of this crisis and how much additional contingent risk this may impose on the sovereign.

We now wait for the details of Moody's banking sector outlook as it takes rating actions on corporates rated at the level of the sovereign or are linked to the sovereign via ownership or guarantees (such as banks, state-owned companies, municipalities and development finance institutions). **We do not expect any changes in corporate ratings on the South Africa National Scale, as these are neutral to changes on the global scale since the sovereign remains Aaa.za wherever its global scale is rated.**

Summary of changes in rating components

Rating factor	Previous baseline	Revised baseline	Rationale for revision
Economic strength	baa2	baa3	• 2020 growth forecast was revised downwards to -2.5% to reflect the negative economic impact of COVID-19 and longstanding structural challenges • As a result, the 10-year moving growth average fell from 1.1% to 0.7%, shifting the sub-factor's score of b2 to caa2
Institutional and governance strength	baa2	baa2	• Under policy effectiveness, fiscal policy has been flagged as being ineffective in stimulating economic growth with the National Treasury struggling to deliver credit-positive fiscal policies
Fiscal strength	ba1	b1	• All plausible scenarios point to a rise in the debt burden over the next five years • Debt:GDP* is expected to reach 77.6% in 2020 and 82.6% in 2021 (previously: 71.3% and 75%, respectively) • Restraining growth in wages will not be enough to halt the rise in debt • The average interest rate is expected to be above growth levels *Includes the majority of SOE guarantees
Susceptibility to event risk	baa	baa	• The factor shifted from being driven solely by domestic political risk to being driven by a combination of domestic political risk and banking sector risk • Banking sector risk was revised down from "a" to "baa" to reflect the difficult operating environment that the economic downturn brings for the sector

Source: Moody's, Nedbank CIB

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