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# PRE-BUDGET CREDIT INSIGHT

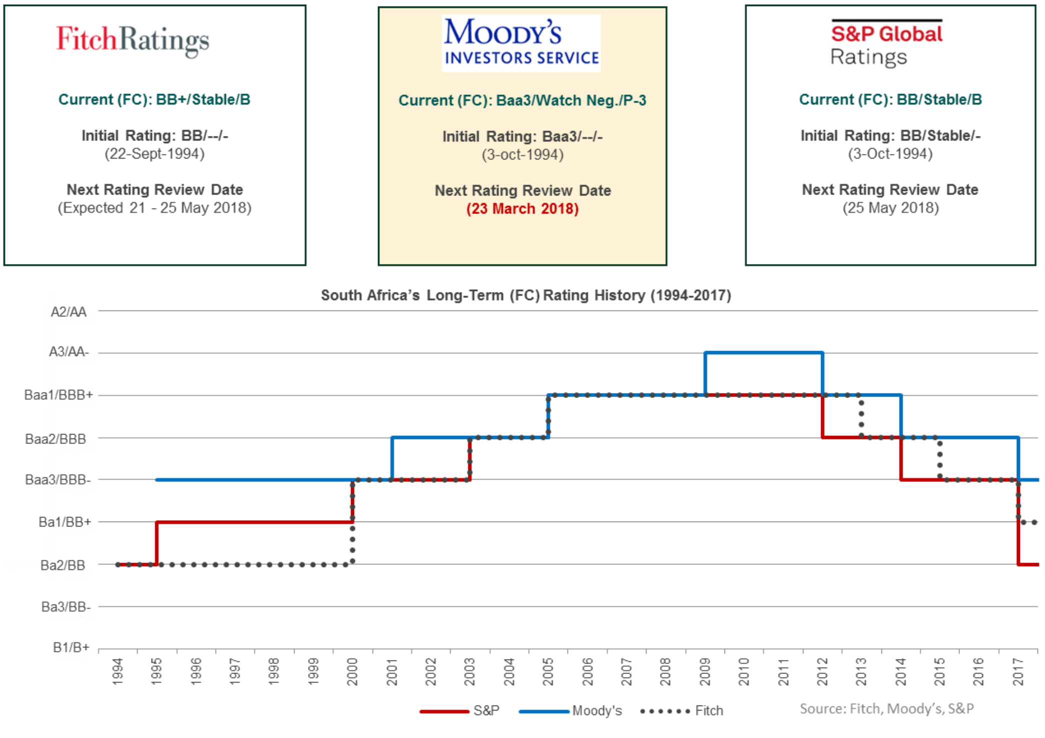
## Kicking The Downgrade Can Down The Road

One of the most anticipated Budget Speeches in South Africa's credit history takes place today, following a bleak Medium Term Budget Policy Statement (MTBPS) in October 2017 and a vexed political transition in government after the ANC's 54th elective conference.

Indeed, all eyes are on Moody's to gauge how they will react to the credibility of Pretoria's fiscal consolidation plan as well as their view on the new administration's political willingness and ability to implement reformist policies in an election year. The sting of the Fitch and S&P downgrades into speculative grade has largely been absorbed and faded by the market, and so the uncertainty remains as to whether Moody's will follow suit – with particular ramifications on South Africa's continued inclusion in the Citi World Government Bond Index (WGBI)?

Moody's is scheduled to review South Africa's sovereign rating on 23 March 2018. The ratings were placed on "review for downgrade" on 24 November 2017. In our opinion, if today's budget is markedly worse than expected, Moody's would not hesitate to lower the rating immediately, rather than to wait for the March release date to resolve the CreditWatch notice.

**Chart 1: Sovereign Rating Agency Calendar 1H18 and Historical Performance YTD**




*Source: Fitch, Moody's, S&P*

Our baseline assumption going into today's budget is that **recent political and policy developments have been credit-positive enough to hold off a Moody's downgrade**, but that the heavy lifting on GDP growth, structural reforms, budget consolidation, and containing the growth in contingent liabilities (through state-owned entity guarantees) will take time and still need to be adjudicated on in terms of South Africa's three-year fiscal forecast horizon. Therefore**, the new ANC administration needs to only show the appetite and willingness to reform and plug the projected 2018-2021 fiscal gap in order to buy themselves more time and kick the downgrade can down the road.** However, these austere measures are unlikely to be growth-enhancing and the lack of fiscal space still makes South Africa vulnerable to existing and new fiscal challenges on the horizon; such as potential state-owned entity (SOE) bail-outs or nettlesome wage negotiations, both which could still induce a downgrade. As such, we think **a negative outlook (or ongoing review for downgrade) at the current "Baa3" rating level (on the cusp of a transition to speculative grade) might still be appropriate**.

## Key Appointments Immediately After President Ramaphosa's Swearing-In Appear To Have Been Tactically Challenging In ANC Politics, Without Consultation. Still, Credibility Is What Is At Stake For The New Administration, From A Credit Perspective

Moody's as an agency is opinion-forward and its analysts provide regular credit commentaries (which are the views of the analyst and not the views of a credit committee) to highlight key credit trends and developments between rating committee review meetings. These commentaries are therefore particularly useful to ascertain the disposition of the analyst on the trajectory of the credit and they perhaps add some colour around the kind of recommendation that could potentially be made in the credit committee. In Chart 2 below, we show Moody's rating actions during President Zuma's administration. We also show the titles of the credit commentaries published by the primary analyst on South Africa during the period. Over the period, President Zuma had four Finance Ministers, with Pravin Gordhan serving two separate tenures. It is quite clear that the credibility of the Minister in charge, and the policies pursued, strongly influence the analyst's opinions. For instance, we know that in Pravin Gordhan's second term South Africa's fiscal and current account imbalances were deteriorating and growth continued to recede – but contrary to the direction of the numbers, the commentary was more credit-positive at Moody's.

Should the market read these commentaries as flippant opinion, or even disregard them completely because they are not the opinion of a rating committee? We do not think these should be disregarded, nor do we think that they are flippant. In our view, they speak to the notion of "benefit of the doubt" that a rating agency can afford a Sovereign; or even the opposite, if confidence and credibility are absent in key institutions or in their leadership this "benefit of the doubt" might be absent.

After the October MTBPS, Moody's tone was very dour, noting that Minister Gigaba's first policy statement signalled a marked credit-negative departure from earlier fiscal consolidation efforts. An about-turn was evident in the last credit commentary in December 2017, after the ANC elective conference, where the Analyst highlighted that the new ANC leadership gave the impression of a credit-positive policy shift, but that the narrow victory complicated consensus on reforms. We could perhaps therefore say that the Moody's analyst is cautiously optimistic about South Africa's credit trajectory and perhaps there is still scope for some more "benefit of the doubt" for the new governing administration. However, we caution that this time it is different, because the National Treasury has suffered a significant loss in institutional confidence since March 2017, following the departure of key staff. Furthermore, the level and trend of fiscal metrics are now far more worrisome than what any Minister or Treasury team have had to contend with in decades. Therefore, in our opinion, restoring technical credibility in the leadership of the Finance Ministry remains one of the strongest credit-positive messages the new administration could make at this juncture.



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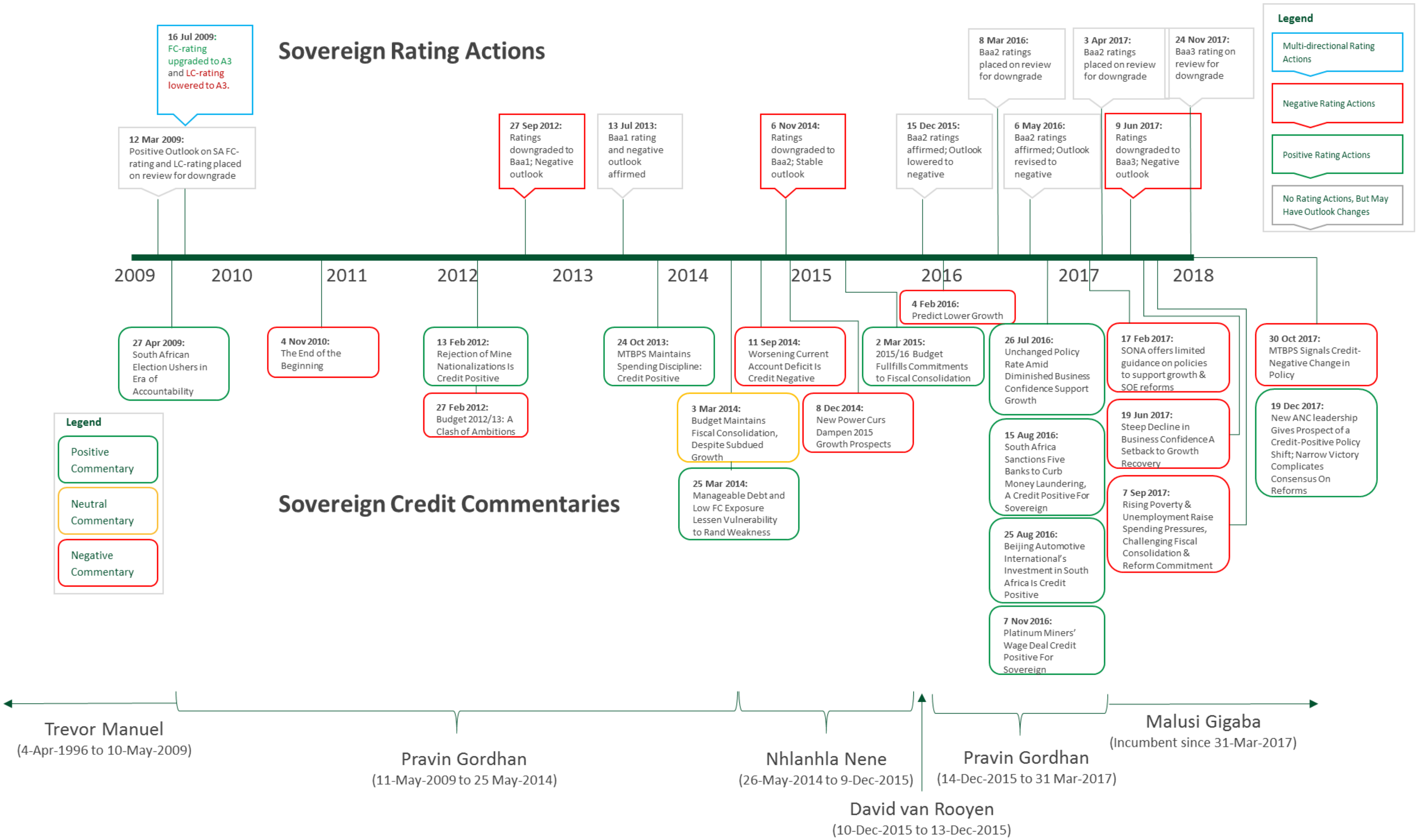
**Chart 2: Between Rating Actions, Issuer Commentaries Provide Insight Into Analysts' Own Views On The Credibility Of Fiscal Administration & Credit Trajectory**



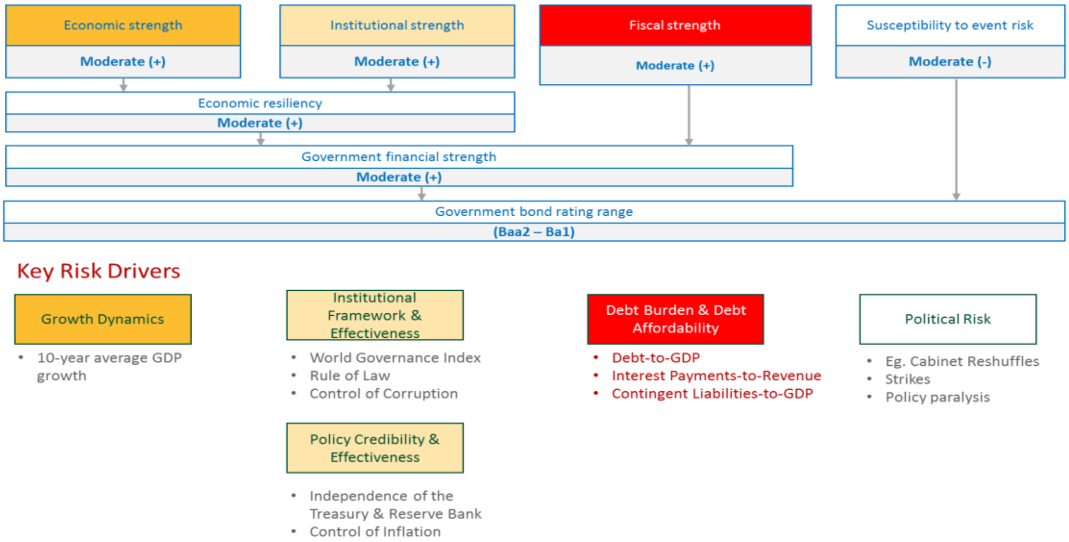

*Source: Moody's*

## Moody's Last Committee Conclusions And Credit Triggers

Rating committee conclusions are published with rating announcements as part of rating agency regulatory disclosure requirements. Moody's last committee conclusion reads as follows:

*"On 21 November 2017, a rating committee was called to discuss the rating of Government of South Africa. The main points raised during the discussion were: The issuer's institutional strength/framework, has decreased. The issuer's fiscal or financial strength, including its debt profile, has decreased".*

**Chart 3: Moody's Sovereign Framework – Fiscal strength is most vulnerable, Economic strength trend is concerning, while Institutional strength could now be turning along with Political event-risk**




*Source: Moody's*

With regards to the outlook statement by Moody's, we highlight the key points in the extract below. In our view both the SONA and Budget Speech will provide answers to:

1. The political economy backdrop and whether it is supportive of stronger institutions and inspires business confidence, investment and growth;
2. Whether the 2020/21 fiscal forecast of the National Treasury has been contained since the MTBPS, with particular emphasis on expenditure-side consolidation policy measures? Obviously, revenue-side measures are expected, but the credit concern will be whether these could be growth-inhibiting at the same time and whether the revenue collection capabilities and governance at SARS can be realistically enhanced?

WHAT COULD CHANGE THE RATING – DOWN

*"Moody's would downgrade the rating if the review were to conclude that South Africa's economic, institutional and fiscal strength will continue to weaken. A downgrade would likely result were the rating agency to conclude that measures to address funding gaps over the next two years lacked credibility or that the lack of progress with structural reforms effort would result in an environment not conducive to investment and growth. Lack of structural reforms would also send a negative signal regarding the strength of South Africa's institutions, in particular about government effectiveness in enacting sound policies. Relatedly, any developments which cast further doubt over the independence and credibility of core institutions including the National Treasury and the Reserve Bank would be strongly credit negative."*

WHAT COULD LEAD TO CONFIRMATION OF THE RATING AT THE CURRENT LEVEL

*"Moody's would confirm the rating at Baa3 if the review were to conclude that the policy response is likely to bring the economic, institutional and fiscal trends on a path so that these factors remain consistent with Baa3 peers; and that developments in the political economy offer the prospect of a more stable, growth-friendly institutional backdrop."*

*Source: Moody's*

# APPENDIX

## Tracking Key Pronouncements – SONA and Budget Speech

We have set out some key questions and issues which we think the rating agencies will be tuned into during the SONA and today's Budget Speech presentation. Further to this, the Parliamentary questions following the budget speech will also be a test of how well the Treasury's leadership has grasped the issues and how credible or defensible its proposed solutions are.

**Table 1: Key Credit Questions and Issues To Track In The SONA and Budget Presentations**

| | | | Yes/No/ Uncertain |
|---|---|---|---|
| SONA | | Even after the eventual swearing-in of President Ramaphosa, is the political environment still fluid and unpredictable? | |
| | | Is a Cabinet reshuffle aimed at the credibility of state institutions or is it a compromise and political patronage in the name of unity in the run-up to 2019 elections? | |
| | | Is there political will in the governing party and the Presidency to improve public governance, accountability, and efficiency by reducing the size of Cabinet and appointing credible leaders? | |
| | | Is there political will to strengthen key state institutions, including law enforcement authorities to combat corruption and state capture? | |
| | | Was there genuine commitment to reform governance at SOEs through credible Boards and CEOs? | |
| Budegt Speech | Policy | Did the Minister of Finance present a balanced macroeconomic policy that promotes growth? | |
| | | Has policy returned towards a definite fiscal consolidation path and control of the fiscus or has the future policy direction given in to social expenditure pressures? | |
| | | Any deliberate statement to underscore the independence of the Treasury and SARB, and how the ANC policy resolution on the SARB's ownership will be implemented? Or has this been kicked into touch and deferred for further consideration? | |
| | | Is there a strong commitment to reform the tax authority while adopting credible measures to improve revenue collection? | |
| | | How was the issue of fee-free education dealt with in the budget? Was it sufficiently smoothed-out over time? | |
| | | Where were the key expenditure cuts (economic or social sectors)? Was there due consideration for the socio-political stability or GDP growth implications? | |
| | Growth | Is the upward revision of GDP growth credible compared to the SARB and IMF? | |
| | | Is the long-term real GDP growth trend (2012-2021) trending towards the 1%-4% range, from 0.1% currently? | |
| | | Is the pace of nominal GDP growth between 2018-2021 keeping pace with the growth in debt? | |
| | | Is the revenue collection target credible and is there due consideration given to the impact of higher taxes on investment and growth? | |
| | | Is the rate and source of fixed investment commensurate with views and trends in the real economy, business/investment confidence, credit growth and is it underpinned by a definitive commitment to structural reforms and policy certainty? | |
| | | Will the investment expenditure in infrastructure be delivered and stimulate growth? Is there a clear commitment to governance reforms at SOEs and is there scope for private participation and investment? | |
| | Debt Burden | Is the level of debt (General Government Debt-to-GDP ratio) still in the 50%-55% range at the end of the last fiscal year and is it forecast outside the 55%-60% range on average over the next three years? | |
| | | Similarly, is Debt-to-Revenue recorded outside the 140%-160% range at year-end and is it forecast to be outside or within the 160%-180% range? | |
| | | Was the fiscal deficit at the expected 4.3% level? Is it still forecast at 3.9%? | |
| | Debt Affordability | Is Cost of debt (government interest payments-to-Revenue) recorded at 12%? Is it still expected to peak at 15% by 2021? Will it be outside the 12%-13% range on average over the next three years? | |
| | Debt Trend | Is the long-run debt trend (% Change in debt-to-GDP 2013-2019) > 10%? | |
| | FCY Debt | Is the level of Foreign Currency Debt as a proportion of General Government Debt > 20%? | |
| | Contingent Liabilities | Are contingent liabilities expected to grow beyond 20% of GDP? What is the likelihood of fiscalization? Is there a credible plan for Eskom's financial crisis? | |

*Source: Nedbank CIB*

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