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South Africa sovereign credit rating

Moody's still holding on to Baa3 Stable outlook rating

Moody's published a credit opinion on South Africa, leaving the rating at Baa3 Stable outlook

Moody's today updated its rating view on South Africa. After Moody's failed to issue a statement about South Africa on the scheduled rating day of 29 March, it was unclear if it would quickly issue a Credit Opinion (as it did a few days after the review in October 2018) or wait until after the elections. That uncertainty has now been resolved, with Moody's publishing a Credit Opinion this afternoon that left South Africa's foreign and local currency credit ratings unchanged at Baa3 with a Stable outlook. While we and seven other economists surveyed by Bloomberg expected Moody's to assign a Negative outlook, the other 50% of survey respondents expected no change. Significantly, in today's Credit Opinion, Moody's still assesses South Africa's fiscal strength – one of the four key pillars in Moody's methodology – to be Moderate (+), unchanged from October, even though the fiscus, both directly and indirectly (via Eskom), has manifested as far weaker than was generally understood at the time of Moody's October Credit Opinion. As we noted in our Instant Insight on Monday (*South Africa sovereign credit rating: Moody's does not issue a rating opinion*), Moody's put out some rather critical Issuer Comments on South Africa's fiscus, including at one point calling the Medium Term Budget Policy Statement a 'credit negative'.

Moody's rating methodology is complicated, but it is still using 2017 fiscal indicators

It is worth parsing Moody's language in the two Credit Opinions carefully, especially around the rationale for maintaining the outlook at Stable and the factors that could precipitate a downgrade. While the broad tenor of the comments below are similar, we do ascertain one important difference, which is that in today's Credit Opinion Moody's talks about South Africa remaining in the range that is 'consistent with Baa3 sovereign credits'. Unfortunately, with such a multidimensional quality as creditworthiness, it is difficult to specify what exactly is 'the range' that is consistent with Baa3 credits. Moody's 28-page sovereign rating methodology lays out how various indicators are aggregated into scores for four key 'factors' that underpin creditworthiness: Economic Strength, Institutional Strength, Fiscal Strength and Susceptibility to Event Risk. The first two are aggregated with equal weights into a score for Economic Resiliency, which then is aggregated again via a mapping grid with the Fiscal Strength Factor, following a nonlinear pattern where the Fiscal Strength factor carries a greater weight for countries with moderate Economic Resiliency (such as South Africa), but a lower weight for countries with high or low resiliency. Then the Susceptibility to Event Risk factor serves as a constraint that can lower the indicative score for the aggregate of the first three factors. Opportunities for adjusting the Factor Scores to account for other considerations exist at each stage. For example, Moody's boosted South Africa's indicative score of Moderate in Fiscal Strength to 'Moderate +' because the structure of the government debt is favourable (i.e. mostly in local currency with long tenor) and 'the government actively manages debt and refinancing risk thanks to pre-funding'. Conversely, Moody's lowered the indicative score in the Institutional Strength from 'High –' to 'Moderate +' because of the 'high-level corruption' of recent years that is not fully captured in the scorecard metrics. And even at the end of the process, there is still room for further qualitative adjustments, since the factor scorecard only produces an indicative bond rating range, which in South Africa's case is Baa1-Baa3.

The complexity of the rating approach aside, one thing that jumps out as to why South Africa's assessment did not change much between October and April for Fiscal Strength: Moody's seems to be using 2017 data. Moody's states, however, that 'While information used to determine the grid mapping is mainly historical, our ratings incorporate expectations around future metrics and risk developments that may differ from the ones

implied by the rating range. Thus, the rating process is deliberative and not mechanical, meaning that it depends on peer comparisons and should leave room for exceptional risk factors to be taken into account that may result in an assigned rating outside the indicative rating range.'

Rating outlook:

October 2018: The Stable outlook balances upward and downward pressures. On the one hand, it reflects policymakers' commitment to reviving growth and stabilising government debt and guarantees over the medium term, which an effective institutional framework will support. On the other hand, the outlook also recognises that these objectives are difficult to reconcile, especially given deep social and economic divisions.

April 2019: While economic growth will remain slow and fiscal strength will continue eroding, we expect South Africa's credit profile to remain in line with those of Baa3-rated sovereigns. We expect that the government's policies and the institutions will remain focused on addressing this trend. However, any reversal will be gradual at best given that social, economic and fiscal policy objectives will remain difficult to reconcile.

Factors that could lead to a downgrade:

October 2018: 'South Africa's ratings would likely be downgraded if it were to become clear that the government will not stabilise its debt burden and contingent liabilities from SOEs, and that prospects for a revival in growth falter. Any crystallisation of contingent liability from SOEs that would raise the government debt burden and place it on a higher trajectory would likely have negative rating implications.'

April 2019: South Africa's ratings would likely be downgraded if we expect that government debt and contingent liabilities risk from SOEs will continue rising to levels no longer consistent with a Baa3, or that medium-term growth will persist at very low levels as recorded in 2018.

While the complex rating methodology might appear to downplay the impact of the fiscal dynamics, Moody's has in a sense clarified it all in the short paragraph on the circumstances that could lead to a downgrade: failure to consolidate the fiscus such that debt continues to rise, or growth fails to rise past the 0.8% recorded in 2018. As we discussed in yesterday's Instant Insight, we believe the jury is still out here. Moody's likely wants to see what the political environment looks like post the elections, and see if the economy and fiscus respond in a positive fashion. Moody's have surprised us with its decision to stay on hold, but we cannot rule out a Negative outlook later if the government does not manage to stabilise Eskom, rein in the budget deficit, and lift growth.

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