Republic of South Africa
Rating Report

BB+ STABLE OUTLOOK

Credit strengths

- A large and well-diversified economy
- Favourable public-debt profile
- Credible monetary-policy framework
- Robust financial sector
- Access to multilateral support

Credit challenges

- Moderate economic growth potential
- Sustained budget deficits and rising government-debt ratio
- Socio-economic vulnerabilities

Rating rationale:

Large and well-diversified economy: South Africa presents one of the largest economies (nominal GDP of around USD 411bn in 2022) of the African continent with furthermore comparatively elevated GDP per capita (USD 6,750) as compared with averages of sub-Saharan Africa.

Favourable public debt profile: Public debt mostly denominated in domestic currency, on fixed-rate basis and with long average maturity, mitigating interest-rate, forex and debt roll-over risks.

Credible monetary policy framework: Strong independence and governance support South African Reserve Bank (SARB)'s efficacy in management of inflation and preserving financial stability.

Strong financial industry: A large and well-regulated financial industry supports economic development and economic resilience to shocks, and mitigates government funding dependency upon fickle international markets. However, an emerging sovereign-bank nexus is a concern.

Ratings challenges include: i) a modest economic growth potential, enervated by unsatisfactory energy infrastructure and high unemployment; ii) rising debt burden in view of elevated expenditure and contingent liabilities; and iii) socio-economic risk hindering structural reform.

South Africa's sovereign rating drivers

Risk pillars		Quantitative		Reserve currency	Qualitative*	Final rating
		Weight	Indicative rating	Notches	Notches	
Domestic Economic Risk		35%	bb+	ZAR [0]	0	BB+
Public Finance Risk		20%	bb-		-1/3	
External Economic Risk		10%	a		+1/3	
Financial Stability Risk		10%	aaa		+2/3	
ESG Risk	Environmental Risk	5%	b+		-1/3	
	Social Risk	7.5%	a-		-1/3	
	Governance Risk	12.5%	ccc		0	
Indicative outcome**			**bb+**		**0**	
Additional considerations					**0**	

Note: *The qualitative scorecard adjustments, capped at one notch per rating pillar, are weighted equally with an aggregate adjustment rounded to the nearest integer. The reserve currency adjustment applies to currencies in the IMF's SDR basket. **In line with our methodology, movements between indicative ratings are not immediate but are executed after analyst review of CVS results. The rating committee approved a core variable scorecard (CVS) rating of 'bb+'. For details, please see Scope's 'Sovereign Ratings' methodology. Source: Scope Ratings.

Outlook and rating triggers

The Stable Outlook reflects our view that risk to the ratings is balanced over the next 12-18 months.

Positive rating-change drivers

- Public-debt ratio on downside trajectory
- Reforms raise growth potential
- External-sector risk profile improves

Negative rating-change drivers

- Public-debt burden deteriorates further
- External-sector risks rise
- Growth outlook significantly weakens

Ratings and Outlook

Foreign currency

Long-term issuer rating	BB+/Stable
Senior unsecured debt	BB+/Stable
Short-term issuer rating	S-3/Stable

Local currency

Long-term issuer rating	BB+/Stable
Senior unsecured debt	BB+/Stable
Short-term issuer rating	S-3/Stable

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Domestic Economic Risks

- **Growth outlook:** Following post-Covid rebound (4.9% growth in 2021), we expect output growth to ease to 1.8% in 2022 before 1.1% for 2023. Volatility in international economic conditions adds to domestic vulnerabilities surrounding electricity-production disruption and closure of petroleum refineries. Government capacity to materially support the economy and anchor recovery from the Covid-19 crisis is constrained by narrow fiscal space. The long-run growth potential is estimated at (just) 1.5% a year despite annual working-age population change of 1.5% a year anticipated over 2022-27. However, South Africa's economy is large and well diversified – with significant tertiary (70% of GDP) and manufacturing (13%) sectors. The economic reform agenda begun in October 2020 (Operation Vulindlela) is the most ambitious and integrated programme to date and should help address economic challenges, although implementation has been tepid. We see authorities reaffirming their commitments to reform during the African National Congress (ANC)'s summit scheduled for December 2022.

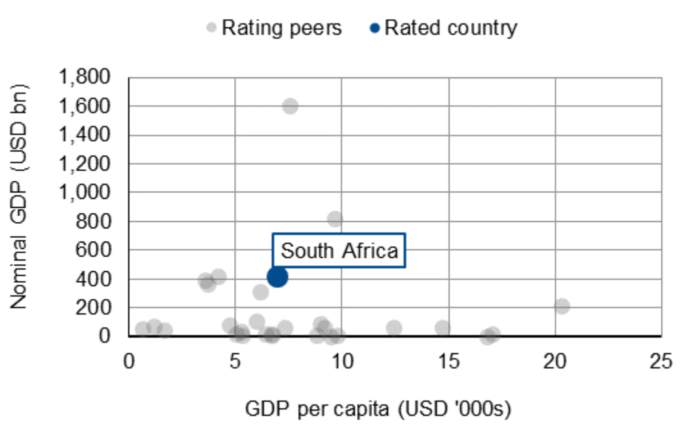
- **Inflation and monetary policy:** Inflation edged slightly lesser to 7.5% in September 2022 and is expected by SARB to stay above a 3-6% target range until Q2 2023 (averaging 6.5% in 2022 before 5.3% in 2023) and converge to the midpoint of said target range only by end-2024. SARB has raised rates six times since November 2021, most recently 75bps to 6.25% last month. We expect the central bank to hike rates further to 7% by end-2022, and 7.5% in 2023. Plans to cut the inflation target range are likely to be delayed until inflation has eased materially.

- **Labour market:** The unemployment rate of South Africa is structurally elevated at 33.9% in Q2 2022, and youth unemployment is 61%. We forecast the national unemployment rate to average 34.4% in 2022 before 35.5% in 2023. We see the jobs crisis persisting medium run given population growth near output growth and outstanding labour-market skills shortages. Labour-market inflexibility constitutes a significant challenge for productivity and investment growth, with South Africa ranked 111th of 141 countries as regards labour-market flexibility according to the World Economic Forum's 2019 Global Competitiveness Index. Rigid labour markets reflect heavy unionisation across public and private sectors.

Overview of Scope's qualitative assessments for South Africa's *Domestic Economic Risks*

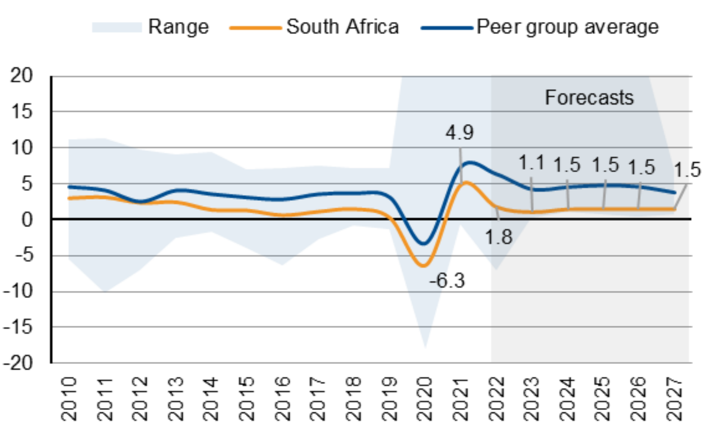
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb+	Growth potential of the economy	Weak	-1/3	Energy and infrastructure bottlenecks and rigid labour markets dampen productivity, investment and long-run growth potential
	Monetary policy framework	Strong	+1/3	Effective management of inflation supported by strong, independent central bank and robust monetary policy framework
	Macro-economic stability and sustainability	Neutral	0	Large and highly-diversified economy anchors resilience to shocks, but inflexible labour market

Nominal GDP and GDP per capita, USD



Source: IMF World Economic Outlook (WEO), Scope Ratings

Real GDP growth, %



Source: IMF WEO, Scope Ratings forecasts

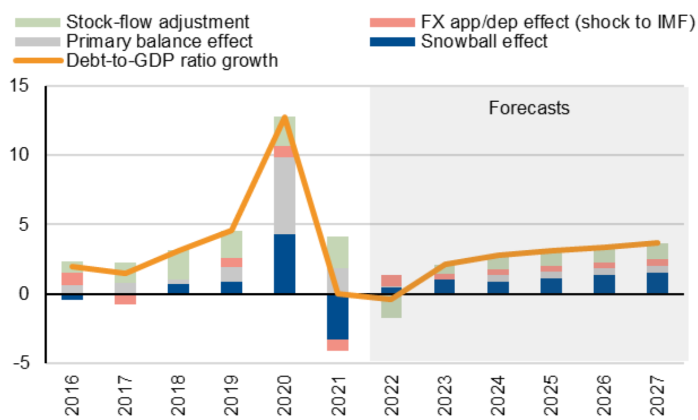
Public Finance Risks

- **Fiscal outlook:** We expect a consolidated fiscal deficit of 4.75% of GDP for FY2022/23 followed by 5.2% for FY2023/24 (reflecting furthermore a balanced primary account by 2023/24 – aligned with government targets). This comes after a 5.3% of GDP deficit of FY2021/22, bolstered by higher-than-anticipated revenue collections last year, down from a 10% deficit in FY20/21. In the 2022 Medium-Term Budget Policy Statement, the government deferred a decision on a permanent income support for the most vulnerable by one year but approved a further extension by a year until end-March 2024 of the Covid-19 Social Relief of Distress grant. Spending rises and non-observation of nominal expenditure ceilings since FY2018/19 represent a core credit weakness – undermining the national fiscal framework. Inflation-linked domestic debt (22% of domestic debt), high demand for transfers and subsidies, and long-standing need for higher public investment weigh on medium-run fiscal sustainability. However, reorganisation of the South African Revenue Service could hike national government revenue (of only 25% of GDP). South Africa's fiscal framework, such as spending ceilings and strong transparency, especially around contingent liabilities, support debt sustainability.
- **Debt trajectory:** We expect the public-debt ratio to rise to 73.5% of GDP by 2024, before continuing to rise medium run. Hence, a government expectation of a peak of the public-debt ratio at 71.4% by FY2022/23 – two years earlier and nearly four percentage points lower than National Treasury had previously estimated – is subject to risk. General government debt to GDP amounted to only 24% as of 2008. Net interest payments will average around 18% of government revenue over the next two years, compared with 8% as of 2008.
- **Market access and debt structure:** Public debt is mostly fixed-rate (74% of the domestic debt securities), denominated predominantly in rand (around 90%) and with long average maturity (of 12 years). This sound public-debt structure curtails interest-rate, forex and debt roll-over risks amid global monetary tightening and current rand volatility. However, long-term sovereign yields have risen around 200bps since February of this year. South Africa remains vulnerable to global policy tightening and shifts of market sentiment as non-resident investors hold around 27% of domestic debt.

Overview of Scope's qualitative assessments for South Africa's *Public Finance Risks*

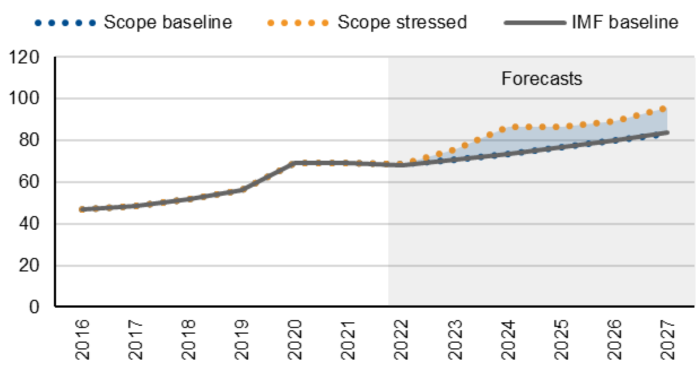
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb-	Fiscal policy framework	Weak	-1/3	The national fiscal framework has been undermined during recent years and has failed to curtail rising debt
	Debt sustainability	Weak	-1/3	Steady rise of the public-debt burden, which is currently elevated by emerging-market standards
	Debt profile and market access	Strong	+1/3	Mostly local-currency denominated debt with long average maturities but high borrowing rates; deep domestic capital markets

Contributions to changes in debt levels, pps of GDP



Source: IMF WEO, Scope Ratings forecasts

Debt-to-GDP forecasts, % of GDP



Source: IMF WEO, Scope Ratings forecasts

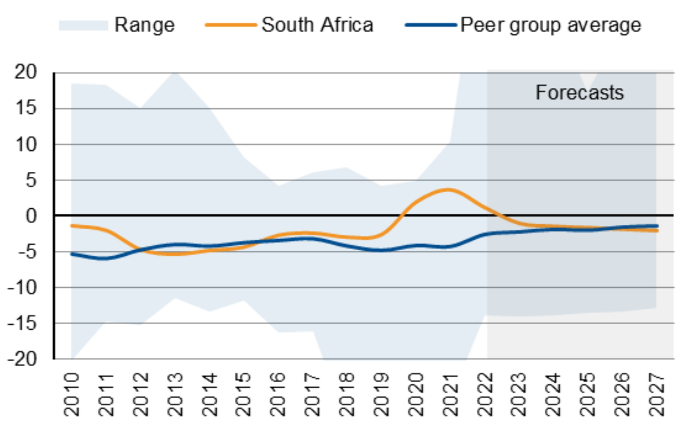
External Economic Risks

- **Current account:** There was a second consecutive year of a current-account surplus (3.7% of GDP) last year. However, rise of fuel prices will result in a smaller surplus of 1% of GDP in 2022, before correction of export commodity prices and higher imports return the current account to an annual deficit by 2023. Still, the trade balance has been exposed to operational disruptions of local petroleum refineries from delays of oil supplies. Pre-pandemic annual current-account deficits were predominantly funded via substantive portfolio equity and debt investment. The external sector of South Africa has been strengthened recently; however, it remains vulnerable during phases of global crises and emerging-market capital outflows.
- **External position:** Net international investment assets amounted to 16% of GDP as of Q2 2022 – with said net external asset position representing a core differentiating factor vis-à-vis ratings peers. External debt has been held to only 40% of GDP as of Q2 2022 with only half of said debt in foreign currency. Above 80% of external debt is long-term.
- **Resilience to short-term external shocks:** The floating exchange rate enables rand depreciation to act as a shock absorber during crises and limit drawdown of official reserves. However, foreign-exchange reserves (of USD 46.2bn as of August 2022) cover only a moderate 64% of short-term foreign debt (on a residual-maturity basis), stronger compared with Covid-19 crisis lows of 46% late last year but weaker compared with the above 100% of the early 2010s. Constructively, the central bank has a long-running policy of restraint from intervening in foreign-exchange markets. The rand has depreciated by 12% against the US dollar since the start of the year, although this has been predominantly a dollar phenomenon – with the nominal effective exchange rate of rand largely unchanged this year. Rand is actively traded and, according to the 2022 Bank for International Settlement triennial survey, contributed at least 1% of global foreign-exchange market turnover.

Overview of Scope's qualitative assessments for South Africa's *External Economic Risks*

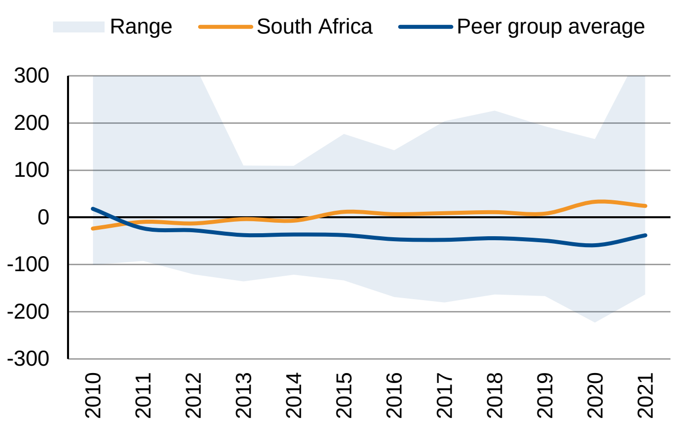
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a	Current account resilience	Neutral	0	Expectation for return to annual current-account deficits although temporary current-account surpluses since Covid-19 crisis
	External debt structure	Strong	+1/3	Manageable levels of external debt with strong debt structure
	Resilience to short-term external shocks	Neutral	0	Moderate levels of foreign-currency reserves, floating exchange-rate regime as a shock absorber, but vulnerable to large and sustained capital outflows; access to multilateral liquidity channels

Current account balance, % of GDP



Source: IMF WEO, Scope Ratings

Net international investment position (NIIP), % of GDP



Source: IMF, Scope Ratings

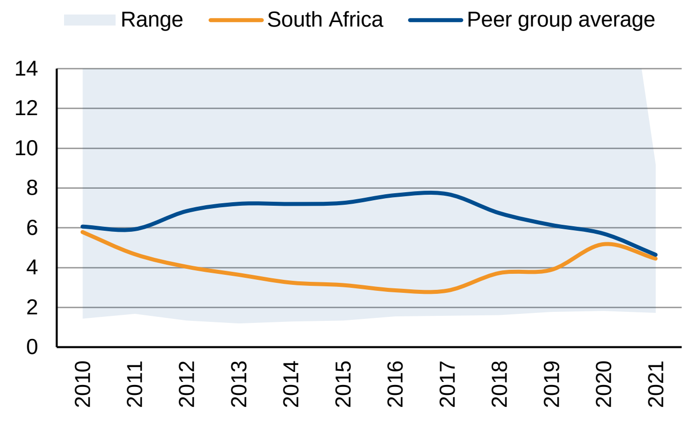
Financial Stability Risks

- **Banking sector:** The banking sector is strong but concentrated with top-five banks holding about 90% of system assets (amounting to 98% of GDP in 2021). Banking-system fundamentals are sound as reflected in strong tier-1 ratios (14.9% of risk-weighted assets as of August 2022) alongside strengthened profitability. Sound bank fundamentals aid resilience to some deterioration of asset quality amid rising rates. Non-performing loans (NPLs) rose to a still moderate 4.7% of gross loans in August. The sound financial system is supported by regulatory oversight of SARB with a domestic financial framework in line with Basel-III requirements. Nevertheless, the economy faces regulatory weaknesses in its money laundering oversight.
- **Private debt:** Indebted households (household debt of 48% of net disposable income as of August) are vulnerable to shocks to their income during current economic slowdown and rising cost of living, as well as vulnerable to higher interest rates. However, corporate debt levels (31% of GDP as of August 2022) are low by comparison with that of ratings peers' economies.
- **Financial imbalances:** Domestic banks' exposures to South African government bonds have risen (from holding 14.4% of domestic government bonds as of March 2018 to 20.3% in September 2022) while holdings of "other" South African financial institutions rose even more substantially (to holding 21.3% of South African domestic bonds in September 2022, from 8.9% as of June 2017). This is as non-resident investors exited (from 42.8% as of March 2018, to 26.8% in September 2022), aggravated recently by global rates tightening. Deep domestic financial markets make available to domestic banks access to significant liquidity – and reduce dependency on foreign-currency financing – curtailing exposure to large-scale refinancing risk or sudden reversals of international investor sentiment. However, an increasing sovereign-bank nexus represents an emerging concern.

Overview of Scope's qualitative assessments for South Africa's *Financial Stability Risks*

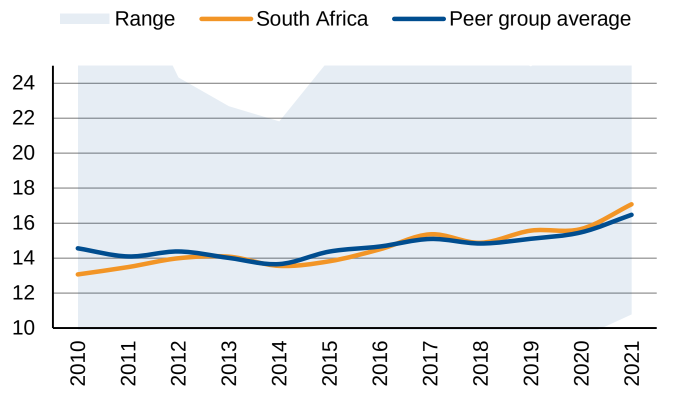
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Strong	+1/3	Robust funding structure with well-developed and deep domestic capital markets, and strengthened profitability
	Banking sector oversight	Strong	+1/3	Well-regulated and resilient banking sector with strong oversight from South African Reserve Bank in line with Basel-III requirements
	Financial imbalances	Neutral	0	Indebted household sector although corporate debt levels are low; rising sovereign-bank nexus although curtailed dependency on international investors

Non-performing loans, % of total loans



Source: IMF, Scope Ratings

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings

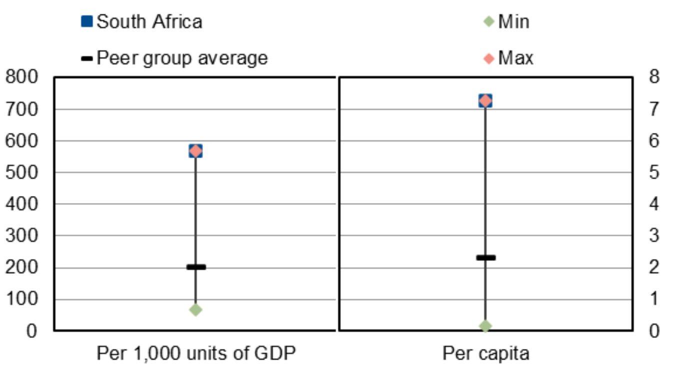
ESG Risks

- **Environment:** Challenges in transition to a decarbonised energy architecture reflect consequences for the core mining and manufacturing sectors. Reducing heavy reliance on coal (which accounts for 70% of energy and some 85% of electricity), diversifying the energy mix, and investing in renewables represent priorities. South Africa signed an agreement with international donors at COP26 to receive USD 8.5bn for coal phase-out and de-carbonisation, although details of the package are still being negotiated. The rehabilitation of domestic electricity production capacity, such as extension of life of the Koeberg nuclear power station, coupled with raising supply via renewable energies, through the Independent Power Producer Programme, will require multi-billion-rand investment. Recent floods in KwaZulu-Natal have damaged infrastructure, presented budgetary costs and disrupted trade operations.
- **Social:** Structural socio-economic vulnerabilities are reflected in high income inequalities and elevated poverty (40% of the population) and unemployment rates. Absent reforms of the labour market and professional training system, we expect tensions around elevated youth unemployment to persist given poor employment opportunities. South Africa benefits from a benign old-age dependency ratio, due to only moderately rise from 12% in 2021 to 17% by 2050 according to the OECD. Demand for social spending ought to stay elevated as illustrated during debate recently around making permanent the Covid-era Social Relief of Distress grant introduced May 2020 and extended to March 2024. A Broad-Based Black Economic Empowerment programme and controversial reforms of land redistribution absent compensation have been advanced.
- **Governance:** As protests last July (one of the most violent since the end of Apartheid) demonstrated, South Africa is vulnerable to civil-stability risks with implications for business conditions. ANC's electoral results weakened in 2021 municipal elections, and the party risks missing out on an absolute majority in 2024 general elections although a fragmented opposition means ANC is expected to retain power. The Zondo Commission highlighted details of state capture under ex-President Jacob Zuma. Acceleration of the Commission's core structural-reform recommendations might enhance perceptions around the control of corruption and bolster the investment climate.

Overview of Scope's qualitative assessments for South Africa's *ESG Risks*

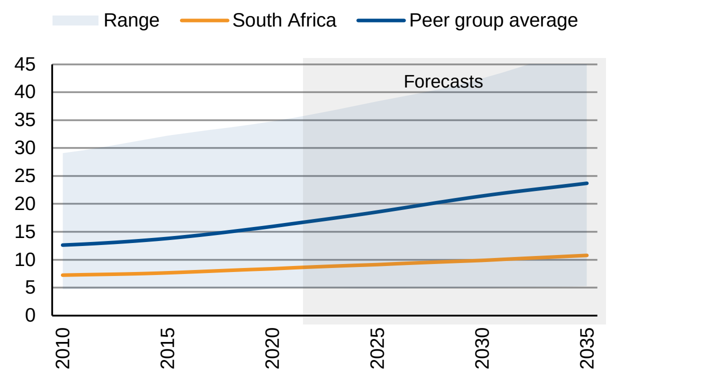
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb-	Environmental risks	Weak	-1/3	Significant greenhouse gas emissions and transition costs as compared with economies of ratings peers
	Social risks	Weak	-1/3	Acute socio-economic risks amid elevated poverty and unemployment; below-average education and health outcomes
	Institutional and political risks	Neutral	0	Comparative political stability; governance challenges remain despite ongoing progress in tackling of corruption

CO_2 emissions per GDP and per capita, $mtCO_2e$



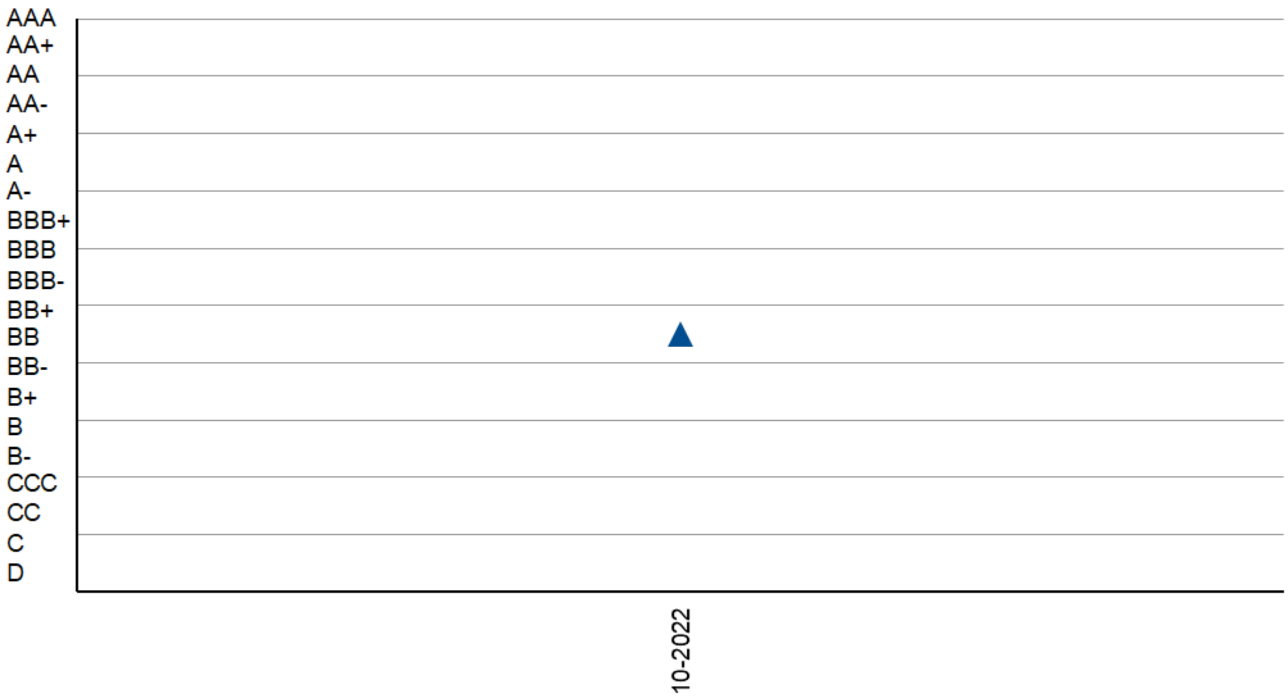
Source: European Commission, Scope Ratings

Old age dependency ratio, %



Source: United Nations, Scope Ratings

Appendix I. Rating history



NB. Positive/Negative Outlooks are treated with a +/-0.33-notch adjustment. Credit Watch positive/negative with a +/-0.67-notch adjustment.

Appendix II. Rating peers

Rating peers are related to sovereigns with an indicative rating in the same rating category or in adjacent categories per Scope's Core Variable Scorecard, including a methodological reserve-currency adjustment.

Peer group*
Georgia
Greece
Serbia
Turkey

*Publicly rated sovereigns only; the full sample may be larger.

Appendix III. Statistical table for selected indicators

This table presents a selection of the macro indicators considered during Scope's ratings process, in line with Scope's Sovereign Rating Methodology. The metrics and sources for the data presented here ensure comparability across global peers and may therefore differ from national and other select international statistics.

Pillar	Core variable	Source	2017	2018	2019	2020	2021
Domestic Economic	GDP per capita, USD '000s	IMF	6,678	6,984	6,599	5,625	6,950
	Nominal GDP, USD bn	IMF	381.3	404.7	387.8	335.3	418.0
	Real growth, %	IMF	1.2	1.5	0.1	-6.4	4.9
	CPI inflation, %	IMF	5.3	4.6	4.1	3.3	4.5
	Unemployment rate, %	WB	27.0	26.9	28.5	29.2	33.6
Public Finance	Public debt, % of GDP	IMF	48.6	51.6	56.3	69.4	69.1
	Interest payment, % of revenue	IMF	12.6	12.8	13.4	16.4	15.7
	Primary balance, % of GDP	IMF	-0.8	-0.4	-1.1	-5.6	-2.2
External Economic	Current account balance, % of GDP	IMF	-2.4	-3.0	-2.6	2.0	3.7
	Total reserves, months of imports	IMF	5.2	4.8	5.4	7.1	5.6
	NIIP, % of GDP	IMF	9.1	11.1	8.0	33.5	25.1
Financial Stability	NPL ratio, % of total loans	IMF	2.8	3.7	3.9	5.2	-
	Tier 1 ratio, % of RWA	IMF	14.7	14.9	15.2	15.0	15.9
	Credit to private sector, % of GDP	WB	127.2	118.6	118.2	112.0	-
ESG	CO_2 per EUR 1,000 of GDP, $mtCO_2e$	EC	636.5	628.9	640.2	639.9	-
	Income share of bottom 50%, %	WID	5.8	5.8	5.8	5.3	5.3
	Labour-force participation rate, %	WB	60.1	60.0	60.1	-	-
	Old-age dependency ratio, %	UN	8.0	8.1	8.3	8.4	8.6
	Composite governance indicators*	WB	0.1	0.1	0.1	0.2	-

* Average of the six World Bank Worldwide Governance Indicators.

Appendix IV. Economic development and default indicators

IMF Development Classification	Emerging Market and Developing Economies
5y USD CDS spread (bps) as of 27 October 2022	304.6

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