Why Morocco is emerging stronger than South Africa from recent crises

Growth, reform help explain divergent rating trajectories

Morocco (rated BB+/Stable Outlook) and South Africa (BB/Stable) lost their last investment-grade ratings and had similar credit strengths and weaknesses at the start of the pandemic. Having downgraded South Africa in October 2023, we explain why the rating trajectories of the two middle-income countries have diverged as they emerge from recent crises.

There are four main challenges – socio-economic, monetary, fiscal, external – that emerging economies such as Morocco and South Africa need to confront amid global economic uncertainty.

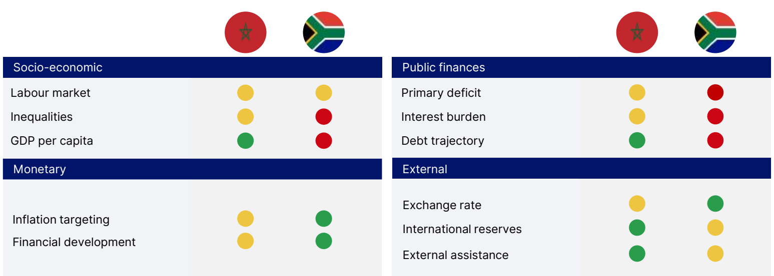
Priorities for such non-investment-grade borrowers include returning to stronger, durable and more inclusive economic growth, which is vital for tackling poverty and inequality. Keeping inflation in check, partly by curtailing exposure to volatile commodity prices, is also important. So too is rebuilding fiscal cushions and containing government deficits while limiting increases in public debt amid today's higher borrowing rates. Finally, countries need to strengthen their external-sector resilience to cope with future economic shocks.

Morocco faces more benign credit challenges than South Africa with its economy growing above potential, a sounder fiscal position and better prospects for reform. This underpins the one-notch rating difference between Morocco's long-term ratings and South Africa's.

Although both countries display similarities in terms of their economic profiles, manufacturing industries and natural-resource endowments, Morocco's stronger growth in per capita output and flattening government-debt trajectory are credit strengths (**Figure 1**). Morocco's greater progress on reform also helps offset challenges in setting monetary policy and managing its exchange rate.

Morocco's close cooperation with the IMF, both on financial-sector and technical fronts, is also a core credit strength. South Africa otherwise scores well on inflation targeting and exchange-rate flexibility but faces policy uncertainties. The outcome of South-African elections this year will define the pace of reform.

Figure 1: Morocco overperforms South Africa on most key economic, social metrics



Source: Scope Ratings

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Table of contents

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Morocco is better positioned to improve its socio-economic prospects

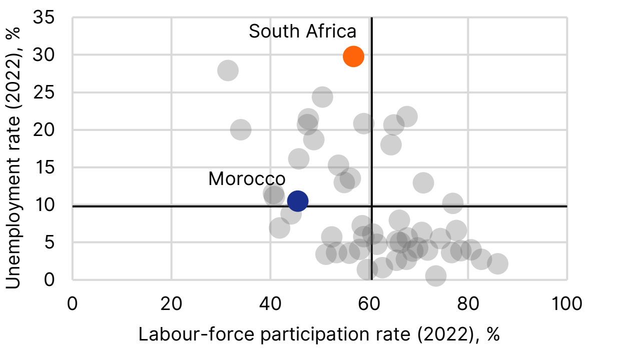
Morocco and South Africa face long-standing socio-economic challenges, notably addressing weak labour markets. Yet, looking ahead, Morocco appears stronger than South Africa due to a less unequal wealth distribution, supporting social cohesion and structural-reform momentum. This underpins Morocco's higher economic-growth potential – twice that of South Africa – and the prospect of per capita GDP converging on South Africa's by the end of this decade.

Morocco and South Africa face weak employment outcomes

Both countries have important labour-market weaknesses. South Africa's unemployment rate is one of the world's highest at around 30%, with youth unemployment above 50% (**Figure 2**). Morocco faces less severe challenges with unemployment broadly in line with the African average of 11%. Youth unemployment is also less high, at around 25%.

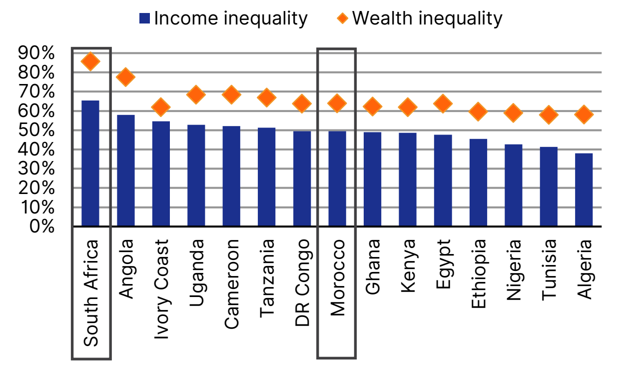
However, Morocco underperforms its African peers with only 46% of its population actively engaged in the labour market, in part due to the very low participation rate of women, at around 25%. South Africa's labour-force participation for those aged 15 and above stands at 57%, which is only moderately below the African average.

Figure 2: Labour-market conditions in African economies, 2022
%



Note: Axes cross at the African continental averages.
Source: World Bank, Scope Ratings

Figure 3: Top-10% pre-tax income and net personal wealth shares in largest African economies, 2022
%



Source: World Inequality Database, Scope Ratings

Inequalities and poverty dent South Africa's social cohesion

In both economies, growth over the past decades has not been sufficiently job-rich and broadly-based to absorb new entrants to labour markets and effectively reduce gaps between the wealthiest and the poorest. South Africa is one of the world's most unequal countries (**Figure 3**).

The combination of weak employment outcomes, widespread poverty, and inequalities increases risks of social tension and weakens public acceptance of reforms necessary to improve long-run economic growth. If left unaddressed, favourable demographics could also become a social burden rather than an opportunity for growth (see previous Scope research).

Morocco's growth potential is twice South Africa's

Morocco's stronger reform momentum should support the economy's greater potential for growth, estimated at 3.0%, compared with 1.5% for South Africa where the economy remains penalised by persistent energy shortages and infrastructure bottlenecks, especially in rail and ports.

South Africa's ageing and unreliable energy infrastructure, a reflection of the mismanagement of state-owned power utility company Eskom, has resulted in persistent load shedding to avoid a more significant failure of the power grid. Load-shedding costs 0.7-3.2pps of GDP growth according to the South African Reserve Bank (SARB), which says a risk of rolling power outages remains high through early 2024.

South Africa's infrastructure problems hold back growth

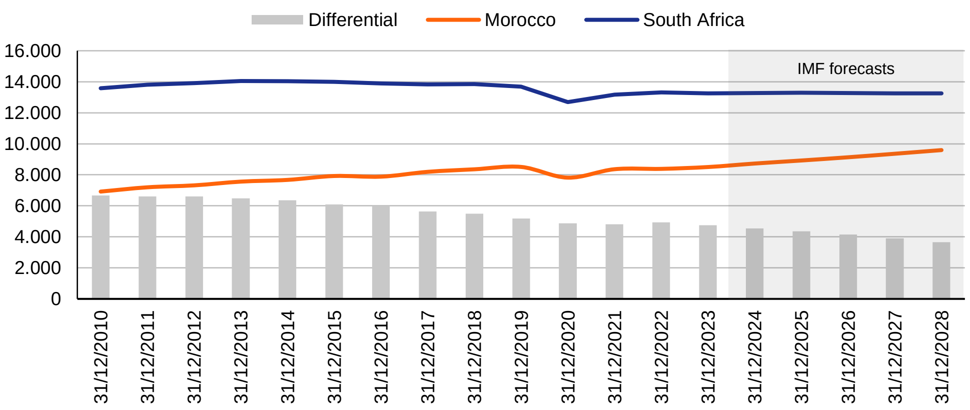
South Africa's infrastructure problems are reflected in near-term economic projections. Although the country has a large and well-diversified economy compared with Morocco's, South African GDP growth is forecast at a below-potential 1.2% in 2024, well below Morocco's 3.4%, even accounting for the effects of the September 2023 earthquake. In the longer run, power outages will continue to curb South African real growth as restructuring Eskom, the rehabilitation of domestic electricity production, and the improvement of transport infrastructure will take time.

Morocco benefits from rising per capita GDP

Overall, Morocco is better placed to tackle its socio-economic challenges given consistent improvements in per capita GDP since the early 2000s (**Figure 4**). Conversely, South Africa's income levels have stagnated and are unlikely to exceed pre-pandemic levels in the foreseeable future. Even worse, the 2015-25 period will probably reflect a lost decade for the South African economy with GDP per capita projected by the IMF to contract 5%, unlike the 13% expansion projected for Morocco. This trend is set to continue. The Morocco-South Africa income gap ought to narrow by 30% by 2028 compared with 2022.

Figure 4: Real GDP per capita

USD at power purchasing parity, international dollars



Source: IMF forecasts, Scope Ratings

Morocco is expected to improve its inflation response

Morocco and South Africa have sound monetary-policy frameworks, but Morocco's responses to supply-side shocks have lagged South Africa's. However, Morocco's transition to inflation targeting is on track, with IMF support and the benefits of a well-developed financial system, which is one of South Africa's credit strengths.

The credibility of monetary policy is pivotal for Morocco and South Africa's credit ratings given its implications for meeting other economic challenges. For example, well-anchored inflation expectations help make economic reforms more socially acceptable. They also lower domestic borrowing rates, supporting private-sector economic growth, and enhance external-sector resilience, allowing the exchange rate to act fully as a shock absorber.

SARB response to cost-of-living crisis has been more proactive

In Morocco, the response of Bank Al-Maghrib (BAM) to recent supply-side shocks and past rises in inflation was considerably slower and less forceful than that of the SARB. Inflation in Morocco peaked around 2pps higher than in South Africa (**Figure 5, next page**).

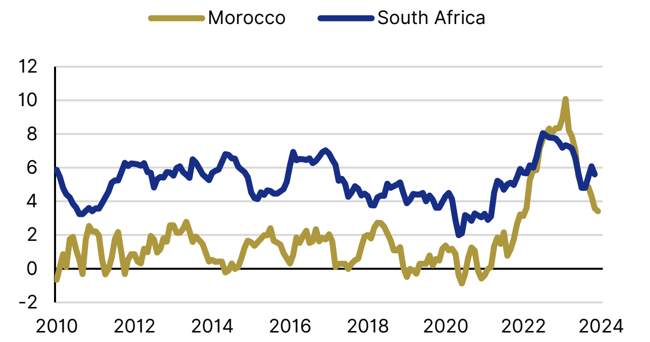
Both central banks raised official rates, with cumulative increases of 450bps (SARB) and 150bps (BAM) between January 2022 and peaks reached last year. Nevertheless, the real policy rate has remained negative in Morocco since end-2021, while it has been positive in South Africa since March 2023 (**Figure 6, next page**).

SARB successfully brought South-African inflation (5.5% YoY in November) back within the Bank's 3-6% target range and below its long-term average (5.2% over 2010-2019). Conversely, Moroccan inflation of 3.4% in December remains significantly above its long-term trend (1.2%), partly due to a weaker monetary response following recent price shocks. Still, we expect inflation to decline from 6.3% in 2023 to 3.5% in 2024, closer to its implicit target of 2%.

SARB reined in inflation

Figure 5: Consumer price index

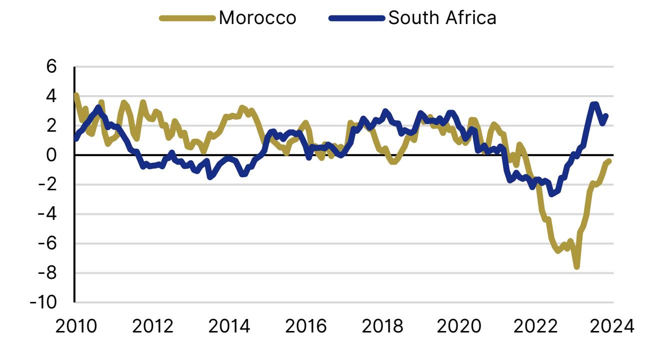
YoY change, %



Source: Macrobond, Scope Ratings

Figure 6: Real monetary-policy rate

%



Source: Macrobond, Scope Ratings

SARB is among the most effective central banks in Africa, reflecting its historical independence, sophistication of its monetary policy, and the country's large and well-regulated banking system.

BAM could bridge the gap with its South-African counterpart over the medium run by continuing to move towards inflation targeting. This could materially enhance its response to volatility in consumer prices, especially in cases of externally induced price rises.

BAM is in the process of introducing inflation targeting

With IMF support, inflation is unlikely to overshoot significantly during BAM's transition to inflation targeting. Morocco could become the first emerging market to adopt inflation targeting without being forced to do so by domestic financial tensions or external pressures, according to the IMF.

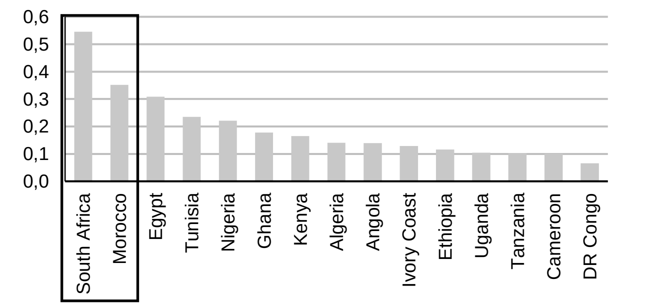
This aside, Morocco's financial system should act as an effective conduit for the transmission of monetary policy to the real economy, not unlike South Africa's. The two countries have Africa's two most-developed financial systems (**Figure 7**).

Morocco benefits from one of Africa's most-developed financial sectors

Morocco has higher financial-system deposits, amounting to 95% of GDP as of 2021, 35pps higher than in South Africa, and higher annual gross savings, which stood at 29% of GDP in 2022, 13pps higher than in South Africa (**Figure 8**).

Figure 7: Financial development of top-10 African countries

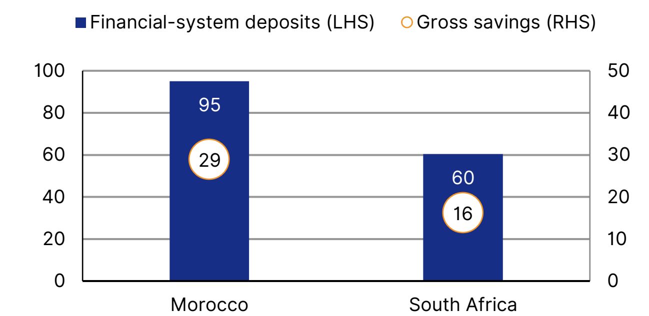
Index scores



Source: IMF, Scope Ratings

Figure 8: Deposit and savings rates

% of GDP



Source: World Bank, Scope Ratings

Morocco's public finances to remain on sounder footing

Both sovereigns have broadly similar fiscal revenues, expenditures and debt ratios. Yet, South Africa's lower real-growth prospects, weaker reform momentum, rising interest burden and more significant contingent liabilities are pushing up debt to GDP whereas Morocco's debt ratio should stabilise medium run.

Higher interest rates will take a toll on South Africa's deficit…

South Africa's primary fiscal deficit will average 0.5% of GDP between 2025-28, against 0.7% for Morocco, with similar public expenditure of around 32% of GDP and structural pressure resulting from high wage growth, social spending, and growing investment requirements. However, the picture changes when accounting for real growth and interest payments, with South Africa's performance to deteriorate markedly over the coming years.

South Africa's headline general government deficit will steadily widen to 8.6% of GDP by 2028, from 4.7% of GDP in 2022 due to a near doubling of its net interest payments to 8.1% of GDP by 2028, from 4.6% in 2022 (**Figure 9**).

By contrast, Morocco's general government deficit will remain contained as the interest burden is set to stabilise at below 3% of GDP through 2028. The difference in yields on the two countries' sovereign bonds reflects the persistence of South Africa's higher risk premium. Although both countries benefit from good market access, South Africa's 5-year USD CDS spread (221bps) is twice that of Morocco (109bps).

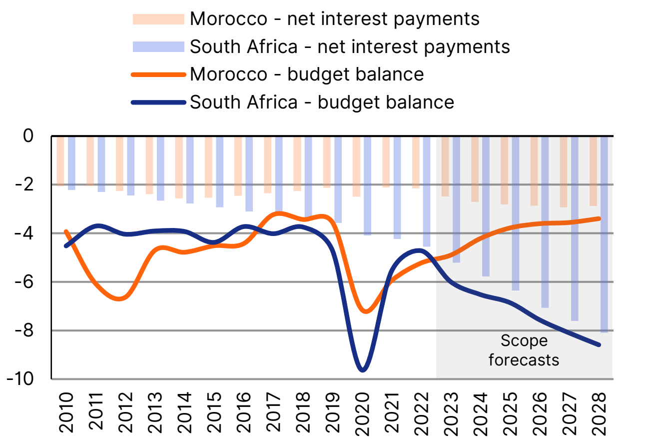
… while Morocco benefits from a stronger GDP growth outlook.

The adverse effects of South Africa's higher borrowing rates are even larger when looking at the outlook for GDP growth. Our projections point to diverging debt dynamics with South Africa's 10-year rand financing rates (around 9.8% in mid-January) exceeding nominal growth (5.9% projected for 2024). Conversely, Morocco's 10-year dirham financing rates (3.8%) will be lower than its nominal growth (6.6% forecast for 2024). As the sovereigns have similarly sized tax bases (27% of GDP), Morocco's more favourable growth prospects point to a stronger outlook for fiscal revenue.

On this basis, despite similar government debt ratios, of around 70% of GDP each in 2022, South-African debt may exceed that of Morocco by more than 25pps by 2028 (**Figure 10**). As a result, South Africa's annual government gross financing requirements will be around 18.5% of GDP by 2028, higher than Morocco's 12% of GDP.

Figure 9: Net interest payments, general government balance

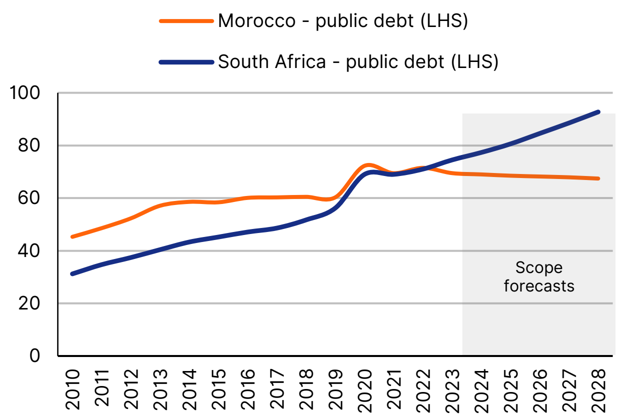
% of GDP



Source: IMF, Scope Ratings forecasts

Figure 10: Public-debt trajectories

% of GDP



Source: IMF, Scope Ratings forecasts

South Africa has significant contingent liabilities. The South-African government is taking on a part of state-owned utility company Eskom's debt, equivalent to approximately 3.4% of GDP.

Morocco's contingent liabilities are more manageable…

Weaknesses on the balance sheets of some other South African state-owned enterprises, particularly in the electricity and transport sectors, raise concerns around the potential for liabilities to crystallise on the government balance sheet. Conversely, Morocco's largest public enterprise, OCP (*Office Chérifien des Phosphates*, owner of the world's largest phosphate reserves) has a stronger financial position, limiting the risk of a government bail-out.

… while its investor base is relatively narrow but less volatile.

Moreover, Morocco benefits from a captive investor base that authorities can tap into due to large domestic deposits as sovereign bonds represent a dominant source of scarce liquid assets. Morocco's investor base presents fewer risks, with foreigners holding 23% of aggregate sovereign debt, against 32% for South Africa.

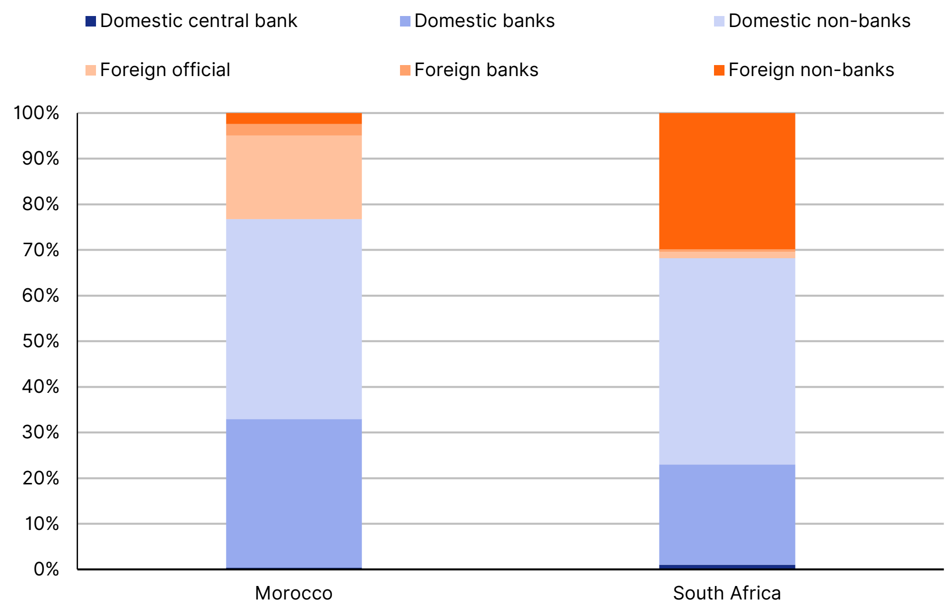
Most (79%) of Morocco's foreign debt is also held by the official sector, while foreign non-banks hold nearly all South-African foreign debt (**Figure 11**). High participation of non-residents in the local-currency South-African government debt market (holding around 25% of outstanding domestic-debt securities) implies higher refinancing risks for South Africa as foreign investors tend to be more unpredictable during phases of global economic uncertainty while non-banks are typically considered a riskier investor class – more prone to herd-like behaviour.

South Africa has a better government debt profile

At the same time, South Africa has access to a highly diversified pool of investors and issues debt across a wide range of maturities and instruments, including inflation-linked bonds. South Africa also has a long average debt maturity of around 12 years compared with seven years for Morocco, a low share of foreign-currency-denominated debt of 12% (24% for Morocco) and limited short-term debt outstanding at 11% of aggregate debt (14% for Morocco).

Figure 11: Public-debt investor base, 2022

% of total public debt



Source: IMF, Scope Ratings

Morocco's robust external sector set to improve further

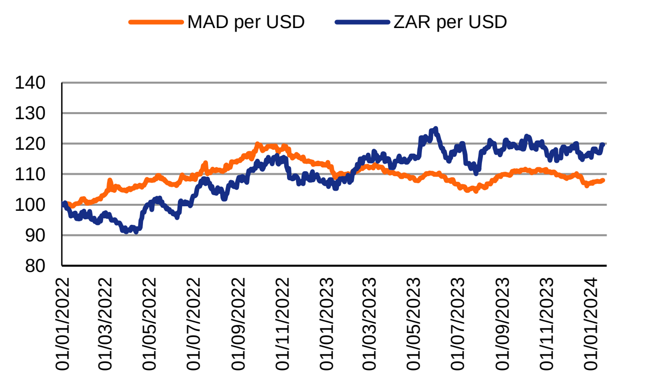
South Africa's floating exchange rate constitutes an effective shock absorber, but Morocco's move to greater flexibility for the dirham should enhance its external resilience, as will a narrowing current-account deficit over the longer run, a relatively stronger business environment for foreign investors, and closer relations with the IMF.

A core disparity relates to exchange-rate policies

South Africa and Morocco have very different exchange-rate systems. While Morocco maintains a pegged exchange rate within horizontal bands, South Africa manages a free-floating exchange rate that has acted as an efficient shock absorber with SARB refraining historically from exchange-rate interventions. In recent months, dirham volatility has been running about equal to that for rand, but since the start of 2022, the rand has depreciated against USD by 17% vs 7% for the dirham as BAM uses a euro and dollar basket (**Figure 12**) to guide the local currency.

Figure 12: Foreign-exchange rates, level

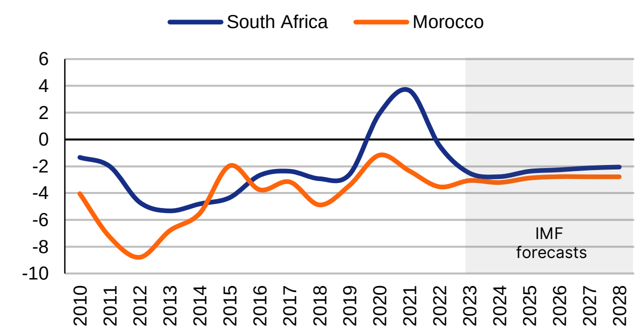
01/01/2022=100



Source: Bank Al-Maghrib, South African Reserve Bank, Scope Ratings

Figure 13: Current-account balance

% of GDP



Source: IMF forecasts, Scope Ratings

In the longer run, BAM's successful transition to inflation targeting is expected to further improve Morocco's external-sector resilience vis-à-vis a more-flexible exchange rate. The dirham is unlikely to overshoot as the liberalisation of the exchange-rate regime reflects a long-term objective rather than an immediate necessity for addressing outstanding external-sector imbalances. The enlargement of the fluctuation band should reflect domestic fundamentals.

Morocco's current-account balance set to improve

The liberalisation of Morocco's exchange rate will likely help reduce the economy's current-account deficit, which ran at 5% of GDP on average between 2010 and 2019, towards that of South Africa, which had averaged around 3% over the same historical period (**Figure 13**).

Greater flexibility of dirham supports external-sector competitiveness and reduces the economy's reliance on imports, improving Morocco's trade balance. The commitment to further economic reforms would also contribute to improving business conditions and help attract additional foreign direct investment.

Conversely, South Africa's challenging business environment could test its external-sector resilience if downward pressures on rand or net foreign capital outflows return. This is notably a risk during phases of emerging-market capital outflows, although the economy's positive net international investment position provides a cushion for its external sector.

Morocco has higher valued-added exports than South Africa

South Africa's dependence on commodity exports results in structural vulnerabilities in its external accounts given volatility of raw materials prices. Prices rose sharply in August 2022 amid renewed geopolitical tensions and have since declined markedly (**Figure 14, next page**).

South Africa's external position is more vulnerable to external crises given commodities represented 65% of exports over 2019-21 (**Figure 15**).

South Africa's economy still reliant on commodity exports

In Morocco, commodities account for less than a third of overall exports, which are mostly composed of higher value-added and manufactured goods.

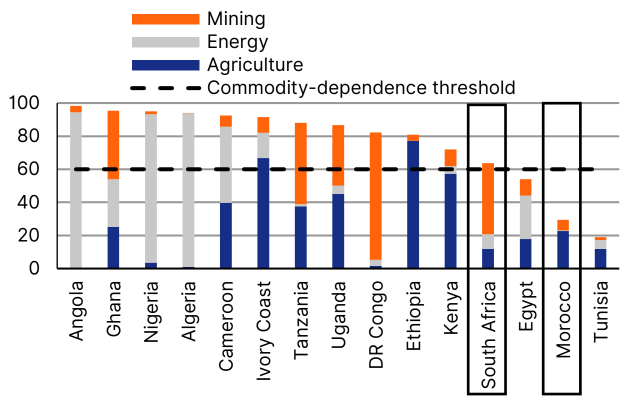
Figure 14: Global commodity-price index

2015=100

Source: United Nations Conference on Trade and Development (UNCTAD), Scope Ratings

Figure 15: Commodity export dependence of top-10 African economies

% of total exports



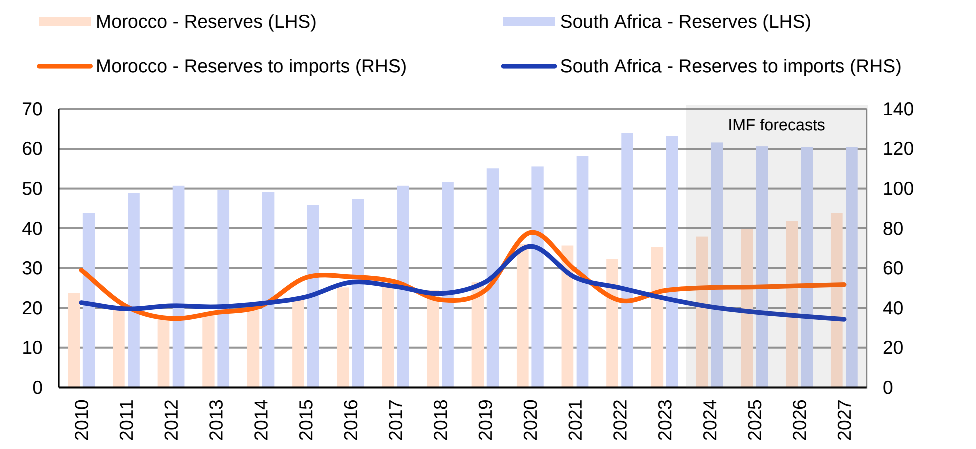
Source: UNCTAD State of Commodity Dependence Report, Scope Ratings

External buffers point to Morocco's stronger external-sector position. As of year-end 2023, Morocco's and South Africa's reserves stood at USD 35bn and USD 63bn respectively, covering around 45-50% of annual imports. Since 2022, Morocco has managed to stabilise its official-reserve assets – illustrating the credibility of its exchange-rate peg against the euro and US dollar – and not dissimilar from South Africa. However, in the long run, the IMF projects Morocco's import coverage to remain stable in the coming years, while it projects South Africa's import coverage to gradually moderate (**Figure 16**).

Morocco has stronger external sector

Figure 16: Official reserves

USD bn (LHS), % of annual imports (RHS)



Source: IMF forecasts, Scope Ratings

Finally, Morocco's external resilience is supported by its close relations with the IMF that enabled the former to secure large and regular financial support (**Figure 17, next page**). Morocco's external

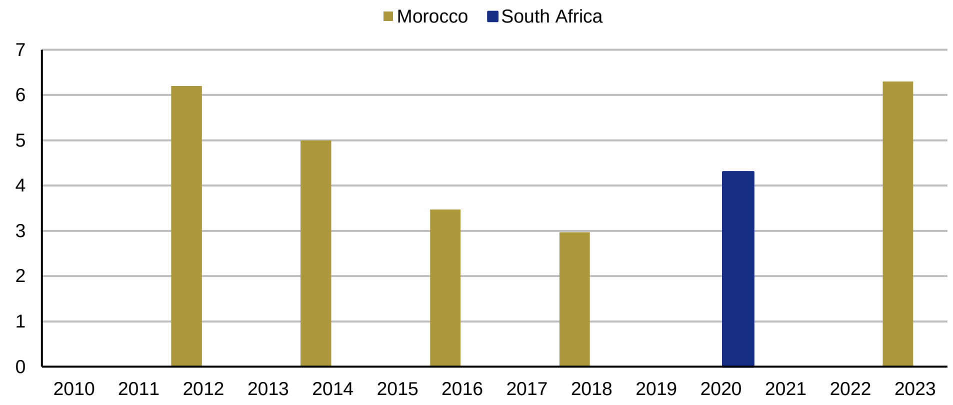
Morocco maintains good relations with the IMF buffers have been bolstered by a two-year IMF Flexible Credit Line of USD 5bn, agreed in April 2023, cementing the government's generally sound relations with the Fund.

Morocco secured USD 1.3bn IMF facility after 2023 earthquake

Morocco has also benefitted from approval of a USD 1.3bn IMF arrangement under the latter's Resilience and Sustainability Facility following the earthquake last September. Morocco's relations with the IMF constitute a core credit strength, enhancing its capacity to cope with external crises and offset transitory vulnerabilities associating with reforms of its monetary-policy framework and exchange-rate regime.

Figure 17: Arrangements with the IMF

Amounts agreed, USD bn*, all instruments combined



*Assuming the USD per SDR exchange rate at the time of agreement. Source: Scope Ratings.

Sustaining reform momentum is crucial for long-term credit quality

Keeping up pace of reform vital for both countries

To address important post-Covid-19 and cost-of-living-crisis challenges, Morocco and South Africa need to pursue and sustain reforms in the coming years in line with their priorities for economic, social, and institutional reforms. The successful adoption of reforms could considerably improve economic development and address outstanding vulnerabilities, enhancing credit ratings in the long term.

Morocco's socio-economic conditions and policy continuity make progress on such reforms more likely. The ambitious and comprehensive agenda of the government's New Development Model programme outlines priorities for the coming decade and enjoys broad support from international financial institutions. Public acceptance of reforms is also more likely given mid-range inequalities relative to African peers.

South Africa needs to overcome governance obstacles

By contrast, South Africa faces significant obstacles in its poor governance, including slow progress in reducing corruption, which hampers implementation of a potentially far-reaching reform agenda set out in October 2020 (Operation Vulindlela). The outlook for reform is further clouded by policy uncertainties ahead of the 2024 elections. Support for the ruling African National Congress remains below its highs, with the party winning less than 50% of votes during 2021 municipal elections, the first time its share of the vote had fallen so low since coming to power in 1994.

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