Rating Rationale

On November 29, 2001, Moody's upgraded South Africa's long term foreign currency debt ceiling to Baa2 from Baa3. Also significant were the rise in the country's short-term debt ceiling to Prime-2 from Not Prime and the two-notch hike in the government's domestic debt rating to A2 from Baa1. The upgrades were prompted by the fiscal, monetary and trade policies instituted over the last few years that have led to structural changes in the economy which enhance its creditworthiness. Low external debt and debt service due to prudent debt management, and an efficient, well-supervised financial system are also key to the assessment.

Fiscal discipline has moved the primary budget balance from deficit into a strong surplus in recent years, while active public debt management has lowered public debt ratios and evened out the maturity profile. The consolidation of public finances has introduced a virtuous cycle of reducing public debt, falling interest rates, and lower inflation. In addition, somewhat more stimulative fiscal policy is now possible after years of restrictiveness as the deficit was being reined in. Expanded delivery of social services (health, education, utilities, housing) will continue, while increased public investment in physical infrastructure and lower tax rates should lay the groundwork for increased potential growth going forward.

The exchange rate has depreciated steadily in recent years (until the last few months when the rand fell more dramatically, it was largely in step with the currencies of other commodity-heavy producers). Still, competitiveness has been substantially strengthened since the devaluation hasn't fully passed through to domestic inflation. The willingness of the Reserve Bank to allow the exchange rate to float without interference over the past two years has provided increased monetary policy flexibility, as well as room to finally eliminate the Reserve Bank's forward book (foreseen during 2002). This is likely to mean that the South African economy will not be as hard hit during the next year compared to past global slowdowns, since a concerted interest rate defense of the exchange rate can be ruled out.

South Africa's success in reducing inflation in the face of the swift devaluation over the past five years can largely be explained by enhanced market competition and wage restraint. Trade barriers were removed swiftly after the multiracial government took office in 1994, and industry has undertaken a massive restructuring in order to survive in the newly competitive environment. However, as always happens in such transformations involving more capital-intensive investment and modernization, many manufacturing sector jobs were lost and this labor shedding has only just now started to bottom out. At the same time, the increasingly efficient labor force and industrial capacity has led to a significantly more diversified export product and market mix, although still heavily commodity-dependent. The increase in real unit labor costs has slowed in recent years, while free trade agreements with the EU and the U.S. African Growth and Opportunity Act are also paying off in fast trade growth with these trading partners, even in this recession year.

On the other hand, virtuous macroeconomic policymaking and improvements in competitiveness are yet to translate into higher foreign direct investment and less volatile capital flows. Combined with the still relatively low level of domestic savings, the inability to attract foreign savings has limited investment and growth dynamism. Policy has also fallen short in addressing some areas of structural adjustment: the delayed privatization of state enterprises has prevented the country from reaping the direct and indirect advantages of those sales when the world economy was more vibrant and valuations high. Current international market conditions are likely to delay planned privatizations still further, limiting the positive impact that they could have had on the capital account and public debt reduction in the near term.

The rating upgrades incorporate the constraints that existing structural challenges, international conditions and certain policy decisions place on South Africa's growth prospects in the near term. Indeed, Moody's strongly believes that employment-creating growth, which has been elusive thus far, remains crucial in order to reduce income inequality, bridge the socio-economic divide, and tackle the issues of high crime and HIV/AIDS treatment and prevention. However, on balance, we are convinced that the clear improvements in the quantitative and qualitative indicators since the rating was originally assigned and South Africa's credit profile relative to its peers justify our decision to raise the ratings.

External Liquidity and Vulnerability

In spite of the rapid decline in the exchange rate vis-à-vis the dollar, low foreign currency debt levels have ensured that South Africa's foreign debt to GDP ratio remains below 25%. The debt service ratio to current account receipts also has been in the manageable 15% to 16% range over the last few years. Improvements in the country's external liquidity are reflected in the ratio of short-term liabilities to BIS-reporting banks relative to assets held in BIS banks, which declined from 168% in 1996 to 93% in 2000.

Other liquidity indicators are less favorable although they all have improved sharply. The ratio of debt payments due within 12 months (short-term plus currently maturing long-term debt) to official foreign exchange reserves declined from 1239% in 1996 to approximately 210% this year, but it remains high relative to South Africa's Baa-range peer group. The country's low level of official foreign exchange reserves (currently about $5.7 billion) relative to its short-term liabilities (currently about $9.5 billion) raise concerns about the country's external liquidity. However, South Africa's short-term debt is mainly comprised of trade finance which are rolled over virtually automatically and thus do not exert pressure on reserves. Also important is the smooth amortization profile, which allows the government to refrain from external borrowing for extended periods of time when market conditions are unfavorable. The well-balanced maturity structure of the government debt meant that the authorities were able to weather periods of global uncertainty without having to pay desperation-level interest rates.

Although trade financing has been steady, South African capital flows have nevertheless exhibited extreme fluctuations in the 6½ years since non-resident capital transactions were freed and the "financial rand" eliminated. These movements, which have tended to be concentrated in the government bond market, have contributed to the weakening of the exchange rate as well as domestic business confidence. However, this volatility also relates to the liquidity of the domestic equity and portfolio markets which in itself could be considered a desirable aspect of any capital market, in spite of the gyrations sometimes inflicted by such capital movements. Still, capital account inflows are unlikely to be stabilized until domestic economic growth itself is substantially higher and more stable.

Banking System Outlook

One of the major strengths of the South African economy is the health of its banking system, characterized by world-class banks and thorough supervision by the central bank. The South African banks rated by Moody's have strong franchises and are in overall good financial condition. They have significant scale, adequate capitalization, and well-focused strategies, and are well organized and technologically advanced. These banks offer sophisticated services and products more akin to those found in developed rather than emerging markets.

At the same time, their tough operating environment continues to present a fundamental challenge to their growth prospects and performance over the long term. We believe that the government's inflation targeting framework of monetary policy will change the interest rate environment and accordingly will test the banks' earning power. In addition, expansion in a low risk and cost-efficient way in an underbanked South Africa will present a challenge for the banks. Nevertheless, we believe that they have room to further broaden their revenue sources and to raise their efficiency by growing their bancassurance and Internet offerings, among other possibilities. In their efforts to achieve greater geographical diversification, several of the big banks have expanded abroad, either to the global financial centers or to regional African countries. Although we view foreign expansion positively over the long term, we recognize that this entails new initial risks for the banks, particularly as regards some of their African operations.

Rating Outlook

Following the November 2001 upgrades, the overall rating outlook is stable. While GDP growth will probably remain lackluster over the next year, South Africa is poised to reap the benefits of a future global upswing. Increases in consumer and producer prices, although moderate thus far, may yet reflect more of the drastic decline in rand value this year. However, the South African Reserve Bank's commitment to its inflation target is incontrovertible and monetary policy will ensure that the target is not breached on a continuing basis.

In spite of the sharp fall in rand value this year (over 30% versus the dollar) and global recessionary conditions, South Africa's balance of payments has not suffered any shocks. The current account will likely maintain the near balance it has achieved over the last two years. The recent offshore listings of a number of large South African companies, with corresponding negative effects on dividend outflows, have sometimes been interpreted as a vote of no-confidence in the system. Moody's view is that many of these companies are just too big relative to the scale of the South African market, and they need to tap the capital available in the world financial markets. These listings are an inevitable consequence of the opening of the South African economy after years of being shut out by sanctions and strict capital controls. The dividend outflows related to these moves have been large at times, yet it is clear that the current account position is still much healthier and more resilient thanks to merchandise export growth and lower external debt service.

Elaborate studies undertaken in the past year regarding show that the HIV/AIDS epidemic will have a meaningful but not catastrophic impact on potential growth, labor force expansion, external accounts, and domestic savings. The human toll, however, will be devastating in terms of death as well as family and community turmoil. Healthcare and other social welfare provisions will have to expand as a result, and the government's resources to address these are regrettably inadequate. In Moody's view, containing the economic, social, and political effects of the pandemic is among the authorities' most serious challenges in the near- to medium-term future.

Rating History

Republic of South Africa

Date	**Gov't Local Currency Debt Rating**	**Foreign Currency Bonds and Notes**		**Foreign Currency Bank Deposits**		**Rating Action**
		Long Term	**Short Term**	**Long Term**	**Short Term**	
10/3/1994	--	Baa3	--	--	--	Rating Assigned
10/2/1995	--	Baa3	NP	Ba1	NP	Ratings Assigned
11/20/1995	Baa1	Baa3	NP	Ba1	NP	Ratings Assigned
7/17/1998	Baa1↓	Baa3↓	NP	Ba1↓	NP	Ratings Placed on Review
10/2/1998	Baa1	Baa3*	NP	Ba1*	NP	Ratings Confirmed
10/12/2001	Baa1↑	Baa3↑	NP↑	Ba1↑	NP↑	Ratings Placed on Review
11/29/2001	A2	Baa2	P2	Baa2	P2	Ratings Upgraded

*¯/- Placed on review for possible downgrade/upgrade. * Rating confirmed.*