POLICY BRIEF

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The Impact of the Ukraine War on the South African Economy [1]

Summary

The current Ukraine-Russia war has created a new multifaceted risk to the South African economy, economic outlook, and thus the making of monetary policy. The war exacerbates supply chain bottlenecks and inflationary pressures via higher energy and food prices which could probably result in a more rapid tightening of monetary policy and impose additional fiscal pressures. Mounting inflationary pressures and rising interest rates will hurt discretionary income and would negatively impact consumer spending, economic growth, employment, poverty, and food security. For UNDP programming, the challenge is designing and implementing effective measures to cushion the effects of the war on the most vulnerable South Africans. At the same time, the impact of the Ukraine war presents UNDP with opportunities to support South Africa's green resilient and inclusive recovery that:

- *addresses persistent challenges of poverty, inequality, unemployment and climate change simultaneously and systematically; and*
- *creates inclusive opportunities to ensure vulnerable population groups are not left behind*

1. Introduction

The war in Ukraine has triggered uncertainty about the recovery of the global economy which was beginning to recover from the COVID-19 pandemic. With Russia being the world's third-largest oil producer, second-largest natural gas producer and among the top five global producers of steel, nickel and aluminium, any significant reduction in energy supplies and metal shipments is highly likely to lead to soaring global prices for these commodities. For this reason, on the day the invasion began, financial markets around the world declined sharply, and the prices of oil, natural gas, metals and food commodities (especially grains) surged. While high commodity prices were one of the risks that had already been identified as potentially disruptive to the global recovery, the escalation of the conflict between Russia and Ukraine increases the likelihood that commodity prices will remain higher for much longer. In turn, it intensifies the threat of long-lasting high inflation, not only for basic needs, thereby increasing the risk of social unrest in both advanced and emerging economies. Industries such as automotive, transport, chemicals, and more generally all sectors using the abovementioned raw materials as inputs appear particularly vulnerable.

Furthermore, considering the scale of the sanctions announced by the Western countries and their allies and the possibility of currency wars,[2] the Russian economy will fall into a deep recession in 2022. Because of its dependence on Russian oil and, above all, natural gas, Europe appears to be the region most exposed to the consequences of the war. While replacing all Russian natural gas supply to Europe (~40 % of total European consumption) is virtually impossible in the short to medium run, current price levels, if maintained until the end of the year, will already have a significant effect on inflation of an additional least 1.5 percentage point in the Eurozone, which will, in turn, erode household consumption and lower GDP growth.[3] While some Eurozone countries, such as Germany and Italy, are more dependent on Russian natural gas, the trade interdependence of Eurozone countries is expected to shave off about 1 percentage point of growth[4] in 2022 from 4.2%[5] to 3.2% due to the impact on external trade and business investment. A complete cut of the Russian natural gas supply would raise the cost to 4 percentage points at least[6] - bringing annual GDP growth to 0.2% in 2022.

The war carries significant risks to the global economy which was forecast to grow by 4.1% and 3.2% in 2022 and 2023, respectively.[7] The moves in commodity prices and financial markets have seen since the outbreak of the war if sustained, could reduce global GDP growth by over 1% this year, and push global consumer price inflation by approximately 2.5%.[8] For developing countries, the war and the doubling of oil prices since September 2021, will shave off about 1 percentage point of growth of 4.6% and 4.5% in 2022 and 2023, respectively.[9] For Sub-Saharan Africa (SSA) countries that had not yet fully recovered from the COVID-19 pandemic downturn, the Ukraine war will prolong SSA countries in recovering to their pre-crisis growth path. Higher food and energy prices are the most immediate source of risk to SSA countries and this will negatively impact poorer countries more.

The Ukraine-Russia war has created a new multifaceted risk to the South African economy, economic outlook, and thus the making of monetary policy. The war exacerbates supply chain bottlenecks and [10]inflationary pressures via higher energy and food prices, which would result in a more rapid tightening of monetary policy. Mounting inflationary pressures and rising interest rates will hurt discretionary income and could negatively impact consumer spending, economic growth, employment, poverty, and food security.

2. The Impact of the Ukraine War on the South African Economy

The economic recovery of South Africa in 2021 has been relatively strong. The National Treasury estimates an output rebound of 4.8%[11] due to the upswing in the global economy, higher commodity prices, the formal end of the COVID-19 third wave and the relaxation of containment measures to level one (the least restrictive) on 1 October 2021. However, the rebound has not improved the unemployment rate [12] amid deteriorating confidence (exacerbated by the July social unrest in KwaZulu-Natal and Gauteng[13] which recorded more than 300 deaths with an economic impact of R20 billion on the KZN GDP and the national economic impact estimated at R50 billion GDP (0.7 % of GDP), [14] anaemic private-sector investment, and weak credit extension. This has been compounded by power shortages that will constrain the post-pandemic recovery with growth expected to slow to 2.1% in 2022 and 1.8% over the medium-term.[15]

The war is expected to cut as much as 0.5 percentage points on economic growth this year[16] which could impact the 2022/2023 budget assumptions and economic recovery from the coronavirus crisis. The war's impact on the economy will flow through three channels:

- Higher energy and fuel prices will increase inflation which in turn will erode disposable income and dampen consumer demand.
- Disruptions to trade and the effects of sanctions will weigh on exports and imports.
- An increase in investor uncertainty will weigh on asset prices and depreciation of the Rand (ZAR), which in turn could potentially spur capital outflows from South Africa.

Russia and Ukraine are major commodity producers, and the war has sparked sharp increases in energy and food prices (see figure 1). In the run-up to the U.S. announcement on 8 March, 2022 of the banning of the import of Russian oil, liquefied natural gas, and coal international oil prices surged to a 14-year high with Brent crude futures hitting US$139.13 intraday.[17] Although global energy prices had already been soaring, following a period of dramatic volatility during the pandemic, the price of Brent crude rose above US$90 per barrel in January 2022. Since then, the Ukraine war has put further upward pressure on oil and gas prices. The impact of rising energy prices has taken in-land petrol prices to over R21 a litre.[18] The effect of the war could result in a further huge increase in April 2022 unless there is a revision of the fuel pricing formula by the National Treasury and Department of Mineral Resources and Energy (DMRE). Coupled with this, it is the country's reliance on open cycle gas turbines for emergency power; that poses a major economic growth risk. With an energy grid still largely reliant on coal, Eskom, the energy's cost base could increase as the coal price surges and demands for exports rise.

The war is also increasing global food prices. Wheat maize and sunflower oil prices have surged since Russia invaded Ukraine on 24 February 2022 as Russia and Ukraine account for about 27%, 14% and 53% of global wheat, maize, sunflower oil and seeds exports.[19] While the inflation in certain commodity prices in South Africa such as gold, maize, palladium, platinum-group minerals (PMGs) and gold could be beneficial to South Africa, the Ukraine war inflationary effect on local food and petrol prices, as well as a possibly more widespread inflation impact from general global inflationary pressures, is likely to be negative, not only eating into consumer incomes to a greater degree but also due to greater upside risk to interest rates, given higher expected inflation of 5.8% this year much higher than the South Africa Reserve Bank's (SARB's) original forecast of 4.9%.[20] Soaring food and fuel prices will have an immediate effect on the most vulnerable, resulting in hunger and hardship for households that spend the highest share of their income on food. But the loss of purchasing power and real spending will ultimately be felt by everyone through the following channels:[21]

- Disruption in shipping, production and security concerns have already resulted in a 50% increase in the price of wheat.
- Russia alone is responsible for 14% of global fertilizer exports, while the inability to export and increase in the price of oil will largely impact fertilizer, fuel, and agrochemical prices.
- Prices of primary agricultural inputs in South Africa are already up by more than 100% compared to January 2021.
- Fertilizers (35% of production costs), fuel (12%) and agrochemicals (8%) are all more expensive than in 2021.

Disruptions to trade and sanctions will weigh on exports and imports. While direct trade between South Africa and Russia, as well as between South Africa and Ukraine, is not substantial, the shock to global trade will have an impact on the country's exports and imports. South Africa exports less than 1% to Russia and Ukraine combined.[22] A similar number is reflected in imports from both countries.[23] The bulk of South Africa's exports to Russia is agricultural, mainly citrus and other fruits, while imports are dominated by copper, wheat, and agrochemicals such as fertilizer. The citrus industry exports approximately 7 to 10% of total South African production to Russia.[24] For instance, South Africa's agricultural exports to Russia and Ukraine combined were valued at R4.1 billion in 2020.[25] The horticultural products, oranges, pears, apples, mandarins, lemons, fresh grapes and wine containers holding 2 litres or less collectively contributed a share of R3.4 billion.[26] As such, the consequences of the conflict and the sanctions on Russia could pose some risks to the delivery and payment for these volumes and the economy unless mitigated by exploring other market opportunities offered through the Africa Continental Free Trade Agreement (AfCFTA).

An increase in investor risk aversion due to the Ukraine war could lead to capital outflows from South Africa, triggering the Rand depreciation, falling stock prices, and higher risk premiums in bond markets. That would create acute stress for the country's fiscal consolidation and target of R1.2 trillion[27] in new investments over five years. Although the Rand has appreciated marginally against the U.S. Dollar since the war started (see figure 2), the local currency could be adversely affected if sentiment towards emerging markets (EM) in general sours as increased global geopolitical tension is generally negative for the rand which could also have inflationary implications on the economy.

3. Implications for Monetary Policy

The additional inflationary pressures from the Ukraine-Russia war are complicating the challenge the SARB faces in tackling rising prices without causing a hard economic landing. Oil is a universal intermediary good that influences the costs of commodities and services, as well as transport costs, in multiple ways.

Oil-price increases can thus be a significant driver of cost-push inflation even at the best of times. Inflation reached 5.7% in February 2022 - close to the upper limit of the SARB's target range of 3% to 6%. The SARB revised its inflation projection for 2022 from 4.9% to 5.8% and at its second Monetary Policy Committee (MPC) meeting in 2022 increased the repurchase (repo) rate by 25 basis points to 4.25%. Evidently, the SARB is raising interest rates and tightening liquidity to fight inflation, which contributes little to addressing cost-push pressure and could cause a real economic downturn.

4. Conclusions and Implications for UNDP programming

The Ukraine-Russia war impact remains highly uncertain, with much depending on how long it continues, its outcome, and what happens in terms of global sanctions, currency wars, boycotts and reactions to them.

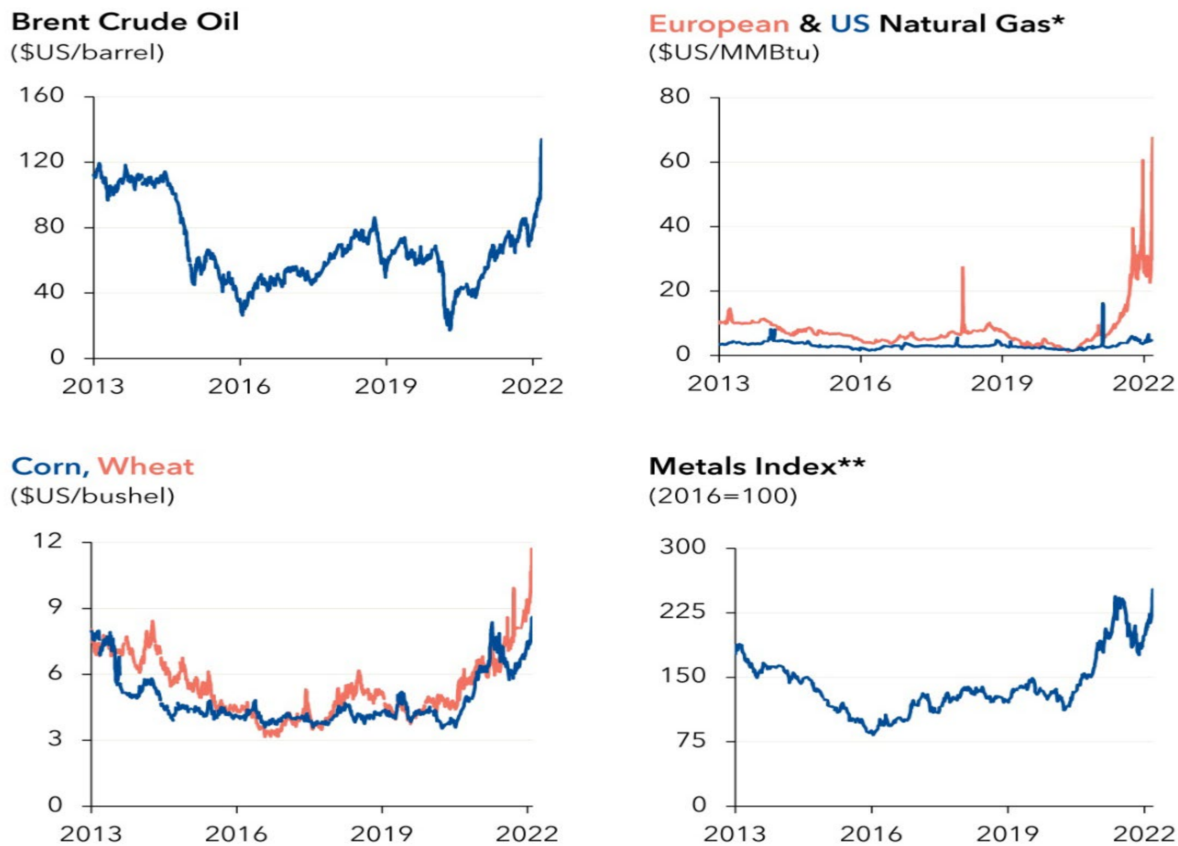
But the seemingly likely impact is an inflationary impact of some magnitude on the South African economy, which in turn heightens upside risk to economic growth, poverty, unemployment, food security, social stability, and short and long-term interest rates.

For UNDP programming, the challenge is designing and implementing effective measures to cushion the effects on the most vulnerable South Africans. Simultaneously, the impact of the Ukraine war presents UNDP with opportunities to support South Africa in:

- developing a holistic financing framework that leverages all financing sources for financing the Sustainable Development Goals (SDGs) and Agenda 2063.
- strengthening social protection systems and/including extending social insurance to the informal sector.
- supporting food security and sustainable food policies through increasing investment in Agritech and other ways of increasing agricultural productivity, and reducing water consumption, among others.
- intensifying support for South Africa's regional integration efforts and the African Continental Free Trade Area (AfCFTA).

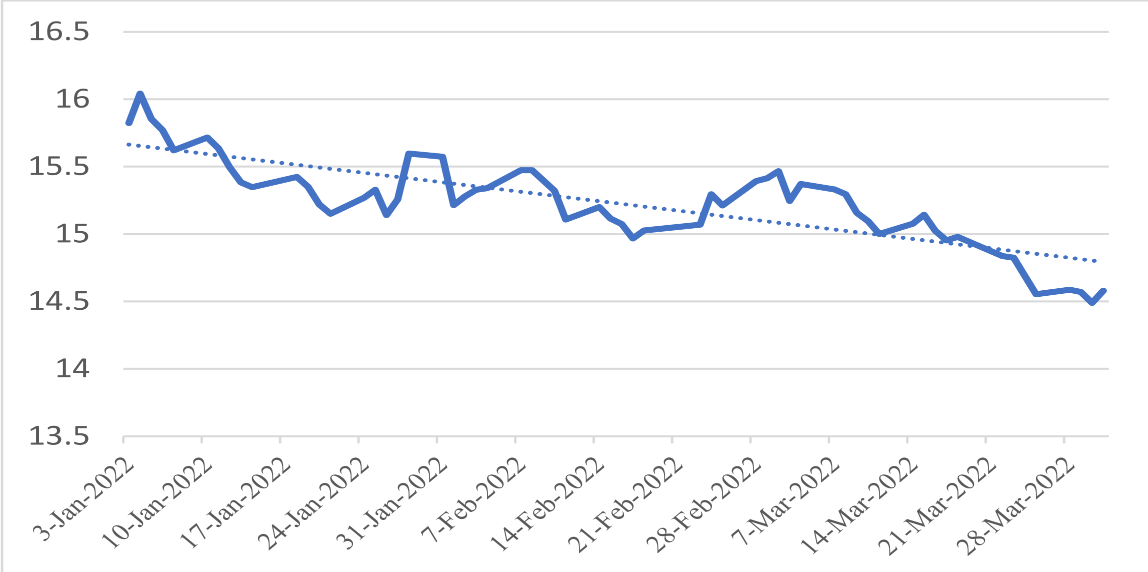
- continuing efforts to support the resilience of the small business sector by focusing on supporting innovative youth entrepreneurship and social enterprises.
- supporting the fast-tracking of fossil fuel subsidy reforms and accelerating the scaling up of renewable energy. And,
- reconstituting the social contract between governments and their citizens and strengthening social dialogue platforms both at local and national levels (what the President of South Africa referred to as a 'social compact' in the February 2022 State of the Nation Address).

Figure 1: Prices for Energy, Grains and Metals Since the Invasion of Ukraine[28]



Source: IMF (15 March 2022) "How War in Ukraine Is Reverberating Across World's Regions," Available at https://blogs.imf.org/2022/03/15/how-war-in-ukraine-is-reverberating-across-worlds-regions/

Figure 2: Rand per US Dollar 3 Jan-31 Mar 2022 (daily rates)



Source: IMF data

Endnotes

[1]This policy brief is an output of the Strategic Policy and Research Unit (SPRU) in the UNDP South Country Office. The Unit focuses on upstream policy interventions in the areas of human development, pro-poor policy analysis, Agenda 2030 for Sustainable Development. It also supports the national and county governments in the design and implementation of evidence based national development plans, provincial development plans, integrated development plans and other relevant policy instruments. The views expressed in this policy brief are those of the SPRU, and do not represent the views of UNDP, the United Nations or any of its affiliate organizations

[2] "Putin tells Europe to pay for gas in rubbles, Available at https://www.citizen.co.za/news/news-world/3056580/putin-tells-europe-to-pay-for-gas-in-rubles/

[3] https://www.coface.com/News-Publications/News/Economic-consequences-of-the-Russia-Ukraine-conflict-Stagflation-ahead

[4] ibid.

[5]https://openknowledge.worldbank.org/bitstream/handle/10986/36519/9781464817601.pdf?sequence=10&isAllowed=y

[6] https://www.coface.com/News-Publications/News/Economic-consequences-of-the-Russia-Ukraine-conflict-Stagflation-ahead

[7]https://openknowledge.worldbank.org/bitstream/handle/10986/36519/9781464817601.pdf?sequence=10&isAllowed=y

[8] https://www.oecd.org/economy/Interim-economic-outlook-report-march-2022.pdf

[9] https://openknowledge.worldbank.org/bitstream/handle/10986/36519/9781464817601.pdf?sequence=10&isAllowed=y

[11] 2022 Budget Speech by the Minister of Finance Mr Enoch Godongwana Available at https://www.parliament.gov.za/storage/app/media/Pages/2022/2-february/23-02-2022_budget_speech/speech.pdf

[12] The latest unemployment rate is 34.9%,with youth aged 15-24 years and 25-34 years recorded the highest unemployment rates of 66,5% and 43,8% respectively (Statistics South Africa, (2021).

[13] The social unrest in KwaZulu-Natal (KZN) and Gauteng (GP) triggered by imprisonment of the former president Jacob Zuma, underpinned by growing unemployment, poverty and inequality.

[14]https://businesstech.co.za/news/government/506136/economic-impact-of-riots-and-looting-in-south-africa-and-wider-emerging-problems/

[15] 2022 Budget Speech by the Minister of Finance Mr Enoch Godongwana Available at https://www.parliament.gov.za/storage/app/media/Pages/2022/2-february/23-02-2022_budget_speech/speech.pdf

[16] https://www.wsj.com/articles/ukraine-russia-wheat-oil-food-developing-world-prices-shortages-11647954514

[17] https://www.drishtiias.com/daily-updates/daily-news-analysis/surge-in-oil-and-natural-gas-prices

[18]https://www.news24.com/wheels/news/disaster-in-the-making-sas-petrol-price-is-expected-to-skyrocket-beyond-r21-per-litre-20220219-2

[19] https://unctad.org/news/ukraine-wars-impact-trade-and-development

[20] At its second meeting of the year on 24 March 2022, the Monetary Policy Committee of the South African Reserve Bank (SARB) voted to increase the repurchase rate by 25 basis points to 4.25% from 4%. The decision followed the hikes by the same basis points in January 2022 and November 2021. The SARB upgraded its 2022 inflation projection from 4.9% to 5.8% due to some upside risks, such as higher food and fuel prices, have materialized, and additional risks, such as currency volatility and capital flow reversals.

[21] https://www.gov.za/speeches/western-cape-agricultural-trade-8-mar-2022-0000

[22] https://www.news24.com/news24/southafrica/news/3-ways-russias-invasion-of-ukraine-affects-sas-economy-20220316
[23] ibid.
[24] ibid.
[25] https://www.gov.za/speeches/western-cape-agricultural-trade-8-mar-2022-0000
[26] ibid.
[27] https://www.news24.com/citypress/business/war-slow-reform-and-blackouts-slow-sas-growth-20220313

[28] European and US gas prices use the Dutch Title Transfer Facility (TTF) and Henry Hub as proxies, respectively. Base Metals Price Index includes aluminium, cobalt, copper, iron ore, led, molybdenum, nickel, tun, uranium and zinc.