Yet another good crisis not to waste

As calm steadily returns after the recent social unrest, analysts are hard at work tallying the cost of the looting and disruption to economic activity. So far, the damage to 2021 growth is estimated at between 0.5ppt to 1.0ppt. These numbers incorporate various media-reported estimates of infrastructure damages, inventory losses, and expected claims from the South African Property Association (SAPOA) and the South African Special Risk Insurance Association (SASRIA). In recent days, various retailers have commented on damaged store counts, while Netstar has provided an indication of the hit to trucking logistics.

The market impact belies the severity of the unrest. Yes, the rand and bonds weakened, but in the bigger context, the declines were muted. This probably reflects two things: firstly, that global conditions tend to dominate, and secondly, that SA assets already embed a substantial risk premium. This does not mean that markets will be impervious to renewed local turmoil, but recent events have not been enough to offset the benefit of high commodity prices, the current account surplus, and the decline in weekly issuance.

Even so, the impact on the economy will be substantial, but it remains difficult to give precise numbers amid limited information. Moreover, the second-round effects must also be considered. We are probably at risk of overestimating the short-term costs and underestimating long-term destruction.

Limited capacity to absorb the damage

A recent report from the IMF[1] on social unrest suggests that the impact on GDP depends on various factors. They find that the impact of a combined political and socio-economic unrest event – such as we have just witnessed (former President Zuma's arrest and the spillover of level 4 lockdown/existing unemployment and poverty) – tends to have a larger negative effect than when it is due only to a political factor or a socio-economic factor. They also find that the impact on GDP is larger in emerging markets (EMs) than in developed markets (DMs). This could be due to the degree of exchange rate flexibility – EMs often have managed currencies, which reduces policy flexibility or amplifies shock events – as well as the degree of product market flexibility – the more competitive product markets are, the more flexible the economy is. Importantly, the impact of social unrest events also depends on the position of the economy before the event and the policy space available to deal with the event.

In SA's case, the economy was already on the back foot prior to the Covid-19 pandemic, let alone heading into the protests, and fiscal and monetary policy have little room to manoeuvre following the hard lockdown in 2020. While the rand is free floating and has done a good job as a shock absorber, SA's product markets are arguably not very competitive given the concentration in crucial network industries.

Employment creation at risk

The constraint of concentrated product markets will very likely intensify in the long term, as the Covid-19 lockdown and the recent unrest have had a greater impact on small, medium, and micro enterprises (SMMEs) than on large businesses. SMME's are crucial for employment creation in an economy, which ultimately should be the government's objective. In an ideal world, government would enable the private sector to create jobs by creating a safe and secure operating and physical environment. Yet, we now find

[1] Hadzi-Vaskov, M, S Pienknagura, and LA Ricci, "The Macroeconomic Impact of Social Unrest", IMF Working Paper, WP/21/135, May 2021

ourselves at risk of private sector disinvestment (which could undo much of the gains from President Ramaphosa's investment drives) and of even greater reliance on the state.

Ratings risk is a BIG deal

On this score, the fiscal demands for job creation and welfare support will continue to build. Temporary support measures, such as the SRD grant, are quantifiable and currently fundable, but a permanent grant, such as universal basic income (UBI) or basic income grant (BIG), will require a dedicated revenue stream as financing. This will be over and above the existing grant system and will be in addition to the rollout of the National Health Insurance. Given the potential negative long-run impact on the tax base, financing UBI will be extremely challenging, if not impossible, in the context of fiscal sustainability.

This brings us to the outlook for the sovereign credit rating. If the potential negative dynamics from social unrest are not arrested soon, then it is highly likely that South Africa will fall further into sub-investment territory. As we have often noted in commentary and presentations, moving into the B-rated credit band implies notably higher borrowing costs to compensate for higher credit risks, as well as less certainty of consistent market access. South Africa would probably still attract some degree of portfolio inflows, but the trade-off will be to pay up for these even more fickle flows.

Yet another catalyst for reform

So what is the answer? Structural reform.

Granted, this is a broad concept that covers a myriad of things, but in our minds, structural reform is something that lowers the cost of doing business, lowers household living costs, and, importantly, enables the private sector to create employment.

Many political commentators have highlighted the opportunity this crisis presents for President Ramaphosa to strengthen control over the governing ANC party, rebuild state capacity, and accelerate long-overdue reforms. The incrementalism that we have seen to date will not be enough to counter the potential deeply negative long-term impact of the Covid-19 pandemic and the recent social unrest. Resilience has bought us time, but resilience is not a substitute for reform.

Conceptual impact of the recent social unrest

Below we summarise the impact, which we divide according to the timeframe:

Short-term impact:

- **Growth:** The impact will be unambiguously negative, as two of the largest – by activity and population – provinces were affected by the disruptions. Gauteng accounts for roughly 34% of national GDP, while KwaZulu-Natal contributes around 16%. The unrest affected the supply side of the economy, via store and road closures, damage to infrastructure, inventory losses, and uncertainty around job security. The disruptions to road and port logistics will have a negative, albeit temporary, impact on exports and imports, while the refinery closure will dent short-term petroleum supply, which will have a knock-on effect through the supply chain. Various commentators have suggested that supply chains in the affected areas could take up to three months to be fully restored.
- **Inflation:** The supply-chain disruptions could lead to higher prices in the affected areas and sectors, but the unrest is unlikely to have a large, immediate impact on consumer price inflation. The exchange rate, aggregate supply/demand balance, and inventory cycle usually influence price formation with a lag.
- **Fiscal position:** The unrest will be negative for revenues via lower net tax receipts, particularly net VAT receipts, as well as lower corporate income tax. The shortfall may be more acute in the retail

sector, given that the damages were most notable to malls and by extension retailers. This would be over and above the loss in excise revenue from the level 4 alcohol sales ban. A measure of the revenue losses may be offset by revenue gains from the positive terms of trade boost.

- **Sovereign credit ratings:** We think the impact is neutral, for now, given that the unrest has petered out. The ratings agencies have flagged prolonged disruption as a negative factor, but the major agencies – Moody's, S&P, and Fitch – have conservative macro assumptions and already high debt levels built into their credit assessments. Granted, if there are further rounds of severe social unrest and attendant anarchy then the impact on the adverse rating dynamics will accelerate.
- **Monetary policy:** The renewed uncertainty and downside risk to GDP growth should make the SA Reserve Bank (SARB) somewhat more cautious on the timing and pace of normalisation. The level 4 lockdown coupled with the protests will very likely dent consumer confidence amid already weak credit growth, the post-Covid jobs shortfall, and subdued income growth. Global considerations remain important, however, but even on this front, the immediate need to raise rates more aggressively has dissipated as the Fed has backtracked somewhat on its perceived hawkishness. Importantly, the rand has remained resilient, which also negates the need for tighter monetary policy in the very short term.

Medium-term impact:

- **Growth:** The upside from the looting is that the anticipated repairs to infrastructure and rebuild in inventories should offset much of the immediate weakness. However, the net effect could still be negative given the hit to business and consumer confidence, as well as the potential for permanent job losses. Even so, supply-chain normalisation will boost local trade activity, as well as exports and imports.
- **Inflation:** Assuming a relatively quick normalisation, the current disruptions are unlikely to have a major impact on inflation. Base effects remain in play, causing some volatility in cyclical inflation. Moreover, weaker confidence and lower income levels should result in lower demand growth than would have been the case, which should offset some of the frictional inflation associated with temporary supply limitations.
- **Fiscal position:** Lower tax revenues associated with business closures will be met with pressure to support employers and households via the Unemployment Insurance Fund (UIF) Covid-19 Temporary Employer-Employee Relief Scheme (TERS) – which was reopened as we went to print – and the highly likely renewal of the Covid-19 Social Relief of Distress (SRD) Grant. Based on the uptake of the SRD grant over the past year, the cost to the fiscus is estimated at around R2bn per month. While it is uncertain how long the grant will remain in place, the fiscal position could absorb much of this support via the contingency reserve, as well as the likely additional revenue overrun associated with the positive terms of trade boost. Hence, there is some room in the fiscal position to absorb temporary measures without derailing the short-term debt stabilisation drive.
- **Sovereign credit ratings:** The degree of support and hit to tax revenues could add to the already negative bias in the rating outlook. However, it will depend on the duration of support and whether there are mitigating factors via reform.
- **Monetary policy:** The monetary policy outlook will depend on the pace of the rebuild, the evolution of inflation and inflation expectations, as well as global policy dynamics. A rapid rebuild and supply-chain normalisation should lead to a renewed focus on policy normalisation, which would be in keeping with expectations for the first hike by the end of the year.

Long-term impact:

- **Growth:** The potential for a sustained negative impact on domestic business confidence, as well as on foreign investor sentiment towards SA will very likely lead to lower investment levels and as a result lower productivity and potential GDP growth. This, in turn, will limit the capacity of the economy to create jobs, resulting in a higher unemployment rate. Lower capex will also reduce the economy's competitiveness in export markets.
- **Inflation:** Lower potential growth and capital formation would lead to a smaller output gap, which, according to the SARB's framework, will contribute to higher inflation. Various analysts have already commented on a short-term stagflation environment – both here and abroad – but a sustained fixed investment retrenchment risks a more durable period of stagflation, akin to the late 1980s and 1990s.
- **Fiscal position:** The combination of a smaller tax base due to lower productivity, business closures, and job losses, will be met with increasing pressure for welfare support. Given already curtailed fiscal space, the government's financial position will come under renewed pressure once the commodity price cycle has run its course.
- **Sovereign credit ratings:** Renewed declines in per capita GDP growth and rapidly rising debt and debt servicing costs will most likely result in another round of credit rating downgrades on a two to three year horizon.
- **Monetary policy:** While lower potential growth would usually result in a lower real neutral interest rate, the SARB's current framework incorporates a risk premium that could more than counter the fall in growth. In addition, if the rand depreciates due to the deterioration in domestic fundamentals – lower credit ratings and eroded productivity differentials – then the FX-induced inflationary pressure would contribute to a higher policy rate. This assumes that the SARB's independence remains intact over the longer term.

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