IMPACT OF THE RUSSO-UKRAINE CONFLICT AND RISING FUEL PRICES ON SOUTH AFRICA’S ECONOMIC OUTLOOK

NATIONAL TREASURY

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THE ECONOMIC OUTLOOK PRESENTED IN THE BUDGET PRECEDED THE RUSSO-UKRAINE CONFLICT. HOW DOES THE WAR IMPACT THE OUTLOOK?

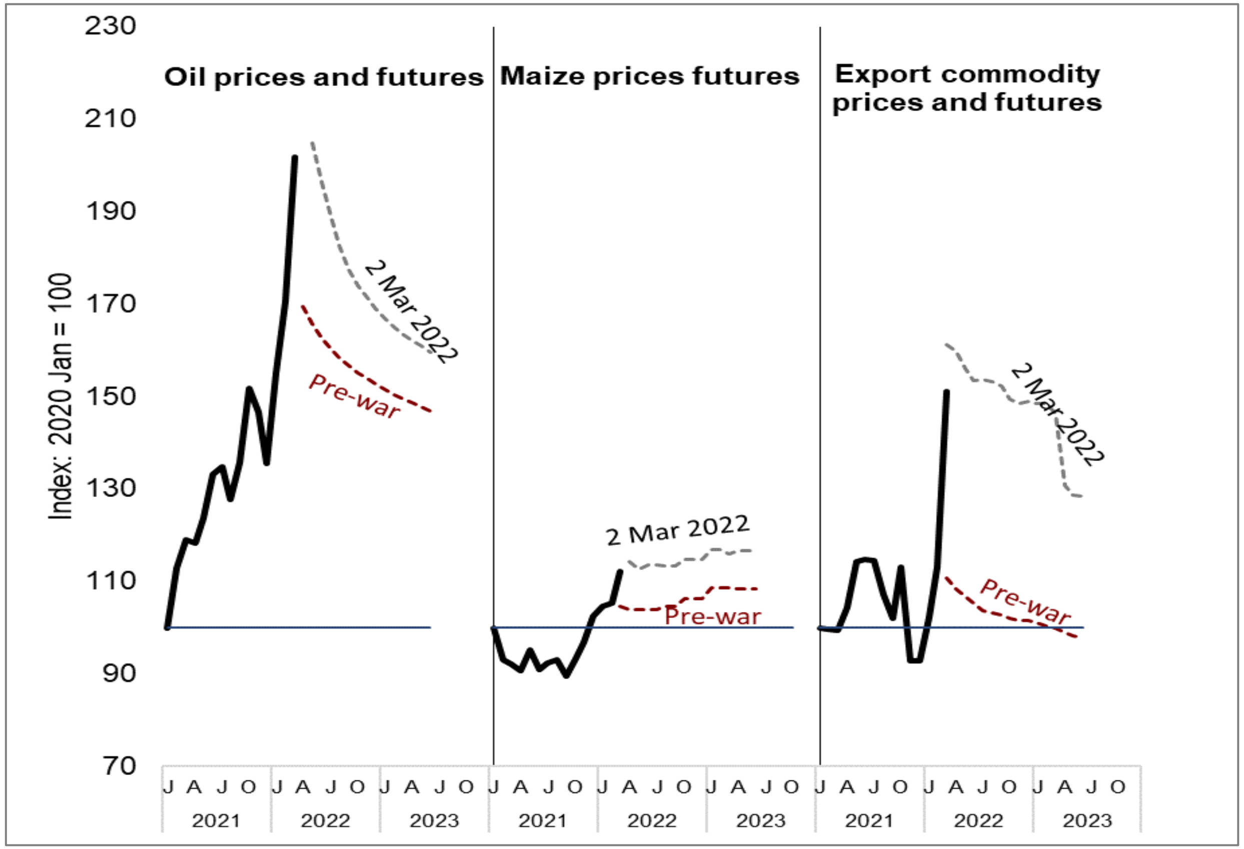
- **There are three main channels through which the conflict could have an impact on our economy: through the real economy, financial markets and investment.**

- **A historical assessment of how the SA economy responds to geopolitical shocks originating in Russia and Ukraine shows a disconnect.**
  - SA is somewhat insulated from geopolitical shocks originating in Russia or Ukraine.
  - Given SA, Russia and Ukraine are all EM's they respond similarly to global shocks, such as the global financial crisis (GFC).

- **The severity of the impact will ultimately be determined by the duration of the conflict and its impact on global supply chains and financial market conditions.**

EXPORT COMMODITY PRICES POSE TAILWINDS TO THE EXTERNAL ACCOUNT, BUT WE FACE HEADWINDS FROM POTENTIAL FOREIGN DEMAND AND IMPORT PRICES

Commodity Prices and Futures Contracts

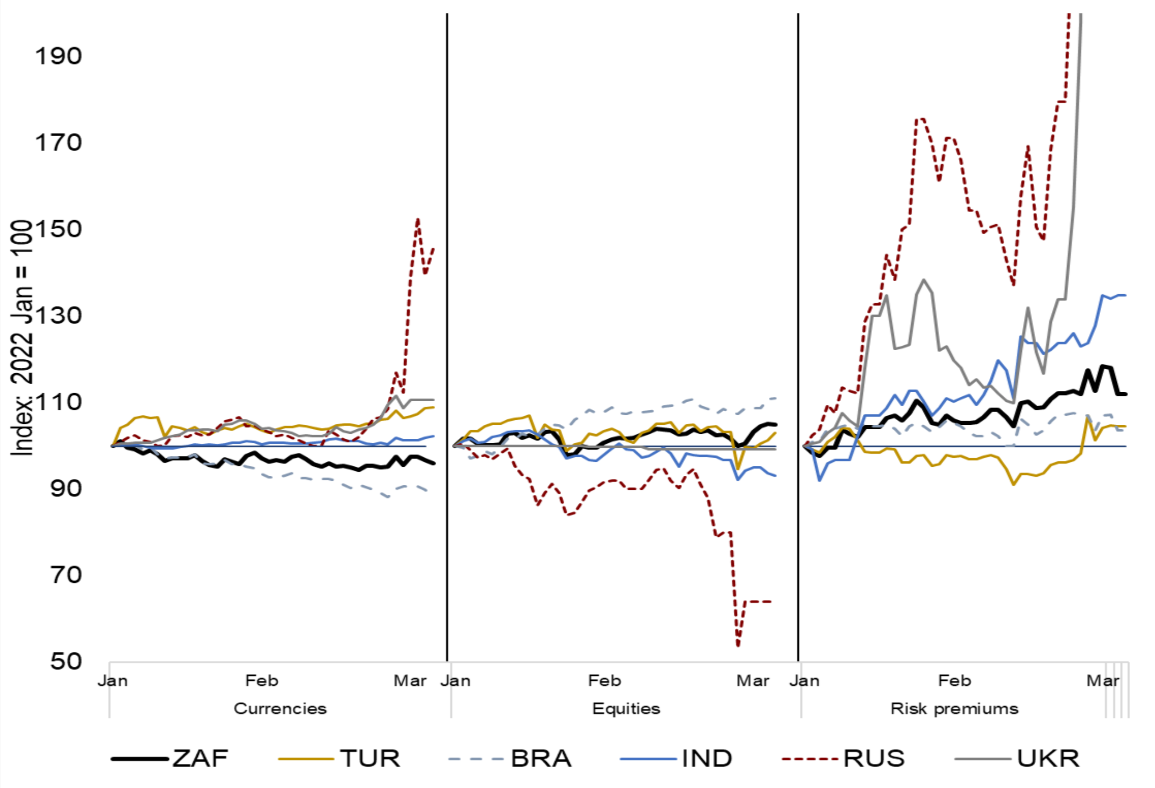


Source: Bloomberg, National Treasury's calculation

- **Russia and Ukraine account for a significant proportion of global maize and wheat production.**
  - Together they account for nearly 30% of global wheat exports.
  - SA consumes 3.4 million tonnes annually of wheat and sources roughly half of this from imports.
  - Therefore, local wheat prices tend to trade towards import parity pricing.
- **Export commodity prices are trending higher compared to before the conflict.**
  - Gold has surged at the back of its safe haven asset status, reaching its highest level in more than a year.
  - Coal and iron ore prices have benefitted from higher demand as some importers are refraining from importing Russia's minerals.
  - PGM prices are also supported by supply concerns as a result of the ongoing war.
- **Import inflation may spill over into domestic inflation.**
  - Concerns about Brent crude oil supplies have seen prices above US$116/barrel as of the 3rd of March 2022 and risks of further spikes.
  - The rise in oil prices and weakening of the rand against the dollar adds pressure to fuel prices (currently more than R21/litre or 33% y/y in March).
  - There are upside risks to food inflation from rising wheat import prices and higher fuel prices.

SA COULD FACE RISKS IN UNSETTLED FINANCIAL MARKETS

Currencies, equities and risk premium of selected EMs



Source: Bloomberg, NT calculations

- **The uncertainty could impact on financial markets in a number of ways;**
  - Higher risk aversion;
  - Higher global inflation prospects**;**

Both could lead to tighter financial conditions and reduced capital flows to emerging markets.

  - The adverse effects of developments in Ukraine have not spilled over to SA significantly, with the Rand having depreciated by only 1.3% in wake of tensions.

- **The JSE remains up on a year-to-date basis, but masks a wide divergence in performance.**
  - Mining stocks (especially gold miners) and other commodity producers such as Sasol have lifted the overall average, while companies with significant exposure to Russia have seen sharp declines.

INVESTMENT LINKS BETWEEN SOUTH AFRICA AND RUSSIA

Company	Investment Amount	Jobs Created	Province
Grand Capital	R 546.6 million	76	Gauteng
Neoflex	R 79.1 million	137	Gauteng
Novolipetsk Steel (NLMK)	R 28.8 million	8	Gauteng
PhosAgro	R 46.0 million	12	Western Cape
Renaissance Capital	R 136.7 million	19	Western Cape
Transmash Holding	R 1,044.4 million	1361	Gauteng
Gazprom Bank	R 119 million	27	Gauteng

Source: FDIMarkets, 2022

- Since 2014, at least 6 notable companies from Russia have invested in South Africa, representing at least R 2.1 billion invested in the economy and creating 1 613 direct jobs. Investments from Russian entities were in ***Fertiliser production, Financial Services, Railway rolling stock and Steel Manufacturing.***
- Sanctions imposed on Russian companies will directly affect these domestic operations if they continue putting at least 1 600 jobs at risk.
- The likes of Barloworld, Mondi, Prosus (a subsidiary of Naspers) and AB InBev (although based in Belgium there is a significant SA ownership).
- **SA’s total foreign assets in Russia are valued approximately at R2bn and total liabilities of R195mn as of end-2020**.

IMPACT OF THE ESCALATION IN OIL PRICES ON CONSUMER PRICES

			Scenario's		
	Budget Review 2022	Oil Price Futures Curve*	*30% increase in the price of oil*	*40% increase in the price of oil*	*50% increase in the price of oil*
Headline Inflation	4.8	5.0	*5.2*	*5.3*	*5.5*
Oil Price ($/barrel)	81.0	96.7	105.3	113.4	121.5
Rands per Litre of 93 octane	19.1	20.3	*21.0*	*21.6*	*22.2*

**Source: Bloomberg as at the 9th March 2022*

- Relative to the Budget Review, and based on oil price future curves – the price of oil for 2022 has increased by just over 19%, with headline inflation now anticipated to register 5.0% for 2022. Likewise, it is estimated that motorists (on average) will pay R20.28 per litre of fuel in 2022.
- The unrelenting **rise in oil prices will continue to place upward pressure on the price of fuel** further eroding household disposable income through increased transport costs.
  - Secondary effects are anticipated to spill over into other parts of the economy. In particular, there are upside risks to the food inflation as a consequence of the higher fuel prices coupled with increasing wheat prices.
- Under the three scenario's, **headline inflation is anticipated to edge towards the upper bound of the Reserve Bank's target range whilst it is estimated that consumers will pay R3.00 more for a litre of fuel, should the price of oil rise by 50% relative to the Budget Review forecast.**

SUMMARY OF IMPACT ON OUTLOOK

- **Budget Review 2022 highlighted the risk of potential persistent supply and demand imbalances driving inflation higher and the prospect of tighter financial market conditions.**
- **The preliminary assessment of how the conflict could directly affect the domestic economy.**
  - Russia and Ukraine are not significant trading partners, accounting for less than 1% of total trade.
  - The rally in export commodity prices stemming from supply concerns would provide a tailwind to the external account, provide added support to the mining sector and a possible windfall to revenue collections.
  - However, the rising oil price, potential weakening of the rand against the dollar, and supply constraints around wheat pose upside risks to food inflation and non-core inflation specifically, with upside risks to headline inflation.
- **Risks to the current assessment will largely depend on the length of time of the Russo-Ukraine conflict, as well as the impact of the sanctions on Russia and Ukraine's trading partners.**
  - Protracted and further sanctions could lead to widespread global inflation and impede the global economic recovery during the pandemic.
  - Europe is particularly exposed to adverse events of the conflict, which could compromise trade activity and entrench the already existing global supply constraints.
  - Such spill overs would adversely affect South Africa's inflation, trade and domestic economic growth.

MITIGATION MEASURES FOR FUEL PRICE INCREASES

- While the recent price increases have largely been driven by the international price of oil (impacting the BFP), a number of short and medium-term interventions can be explored to efficiently determine the levels of the other components of the fuel price.

Short term interventions

- In the Budget for the 2022/23 FY, the Finance Minister **announced no change to the RAF levy and the general fuel levy**. This intervention was implemented to provide immediate relief from the impact of price increases and will result in a reduction in revenue of R3.5 billion.

- In 2018, the DMRE undertook a review of the BFP components of the petrol price. Proposed recommendations from the review can be implemented immediately – **with a potential once-off 3 - 18 cents/litre reduction in the petrol price.**

Medium term interventions

- As announced by the Minister of Finance, a review of all aspects of the fuel price is under consideration by the National Treasury and the DMRE. Adjustments to the RAF levy are dependent on the re-introduction to Parliament and implementation of the Road Accident Benefits Scheme (RABS) Bill. It Is critical that that the parliamentary process regarding this bill is reinstated.

- The DMRE will, in addition to the BFP review, undertake to review regulated margins determined through the regulatory accounting system (RAS). Initial research has shown that **changes to the RAS methodology components can reduce the petrol price by 85.82 cents/litre.**

- Consideration should be given to a price cap which was previously considered by the DMRE.

BASIC FUEL PRICE

DMRE proposed review of elements of the Basic Fuel Price

- In 2018, the DMRE published a discussion document on the review of the BFP, where the department recognised concerns with various assumptions in the methodology.
- For instance, being an import parity methodology, the DMRE acknowledged *that the total amount of imported products versus the total products manufactured locally is not factored into the pricing formula to determine the prices in South Africa* – therefore does not reflect the country's transition to being a net importer.
- The proposed changes to the methodology will cover aspects of updating the composition of reference markets for our imports; the removal of the premium to freight costs; and refining assumptions to introduce more efficiencies.
- **The impact of the full list of changes is estimated to be an 18 cents/litre reduction in the BFP if the DMRE's proposed regulatory amendments are implemented (Crompton et al. 2020).**
- DMRE has indicated that changes to the reference markets and the premium on the freight rate will reduce the price by approximately 3 cents/litre.

PROPOSALS FOR RAS METHODOLOGY REVIEW

Review of the RAS Methodology

- Findings of the petrol price regulation studies commissioned by UNU-WIDER have shown that in addition to implementing changes to the BFP, further work can be done to amend the RAS methodology.
- The areas of the methodology review include:
  - *Appropriate WACC* - The retail margin may be inflated due to assumptions to the weighted average cost of capital (WACC).
  - *Benchmark for operating costs and service station asset base*- The asset base for a benchmark service station and benchmark operating costs may not be regularly revised.
  - *Consistency in real v nominal values* - There might be an inconsistent use of real and nominal figures and pre- and post-taxation figures for the elements in the Capital Asset Pricing Model (CAPM) and WACC calculations.
  - Assessing the need for the entrepreneurial compensation, which provides compensation over and above the WACC.
  - *Small stock premium* - The 5% small stock premium (SSP) factored in, implies that larger-volume service stations benefit from the regulator classifying them as smaller service stations.
- **If implemented, changes to the RAS methodology components can reduce the petrol price by 85.82 cents/litre**.

TAXES AND LEVIES

NT regulated levies make up just over 30% of the pump price, and above inflation increases in fuel taxes since 2014 make up a substantial contribution to fuel prices

- The general fuel levy plays an important role in supporting the fiscus, and the RAF levy is earmarked to the RAF. This has also informed above inflation adjustments in the past.
- The reduction in the level of the fuel levy will have implications for the fiscus (accounts for ~6% of total tax revenues) and any lost revenue will have to be recovered through alternative revenue sources.
- Prioritising the Road Accident Benefits Scheme (RABS) Bill and benefit limitations of the RAF are important reforms, however further discussions required with the Department of Transport.

FUEL PRICE ANNEXURE

CONTEXT AND BACKGROUND

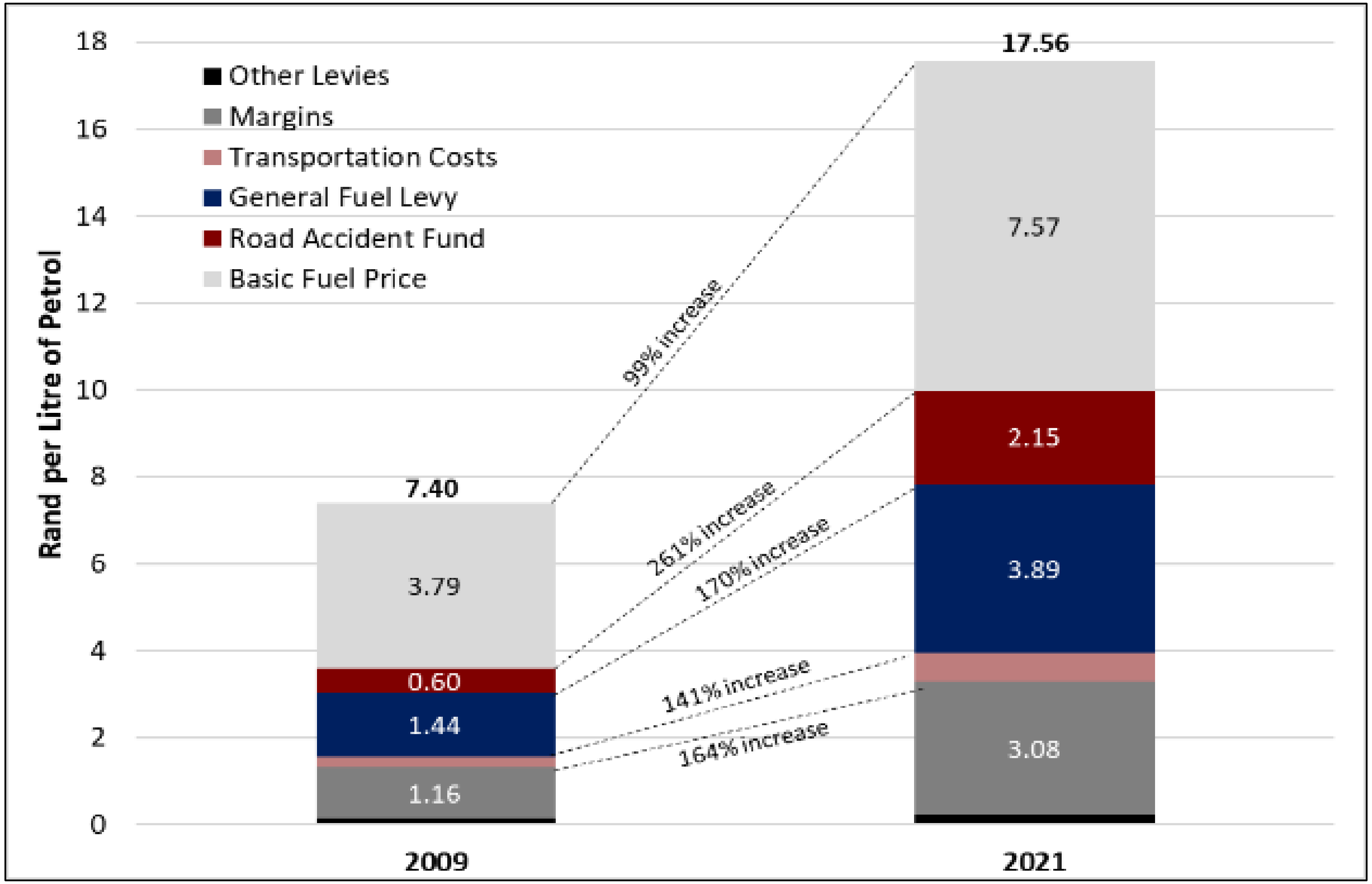
Regulatory environment

- Historically, regulation in the petroleum sector has been designed to protect the domestic industry from import competition. It would seem that government's interventions in the petrol market to date are aimed at: import substitution industrialisation; security of supply; achieving affordable prices; promotion of small businesses; and employment opportunities (Crompton et al. 2020).
- Support for the domestic industry has also been reflected by generous margins within the pricing framework. The result has been the proliferation of petrol service stations – which the department has driven as an industrial strategy, also supporting employment (through the requirement for full service at stations).
- The White Paper on Energy Policy (1998) set the policy objective **for a phased transition to deregulation and the removal of price controls within the liquid fuels industry** but this has not materialised.

Recent developments

- The National Treasury Growth Paper recommended that regular reviews of the prices and their underlying formulae need to become the norm to ensure these are updated to reflect the latest available information and international best practice.
- The upward trend in oil price, which is reflective of robust demand recovery and geo-political tensions, increasing supply restrictions and surging gas prices, has placed upward pressure on domestic petrol prices.

The share of taxes, levies and margins has more than doubled over the last decade, with the increase in the oil price placing further upward pressure on the overall fuel price

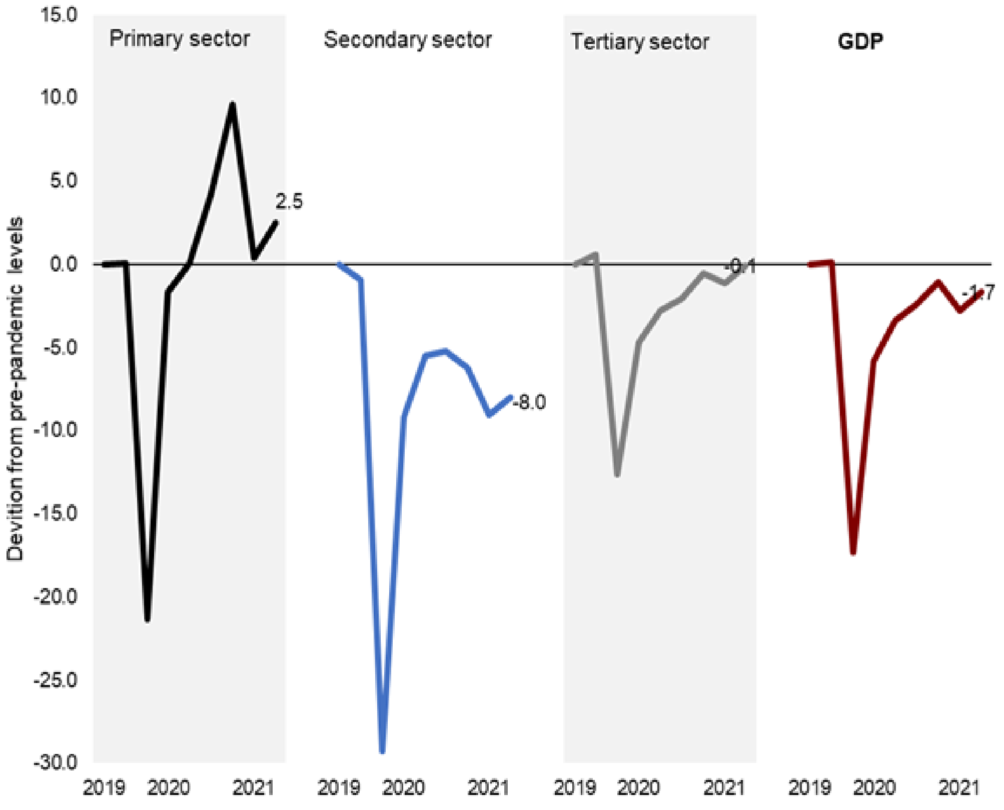


Source: Eskom, Stats SA, Department of Energy

GDP ANNEXURE

REAL GDP (FROM THE PRODUCTION SIDE) EXPANDED BY 1.2% Q/Q SEASONALLY ADJUSTED BASIS IN THE FOURTH QUARTER OF 2021

Figure 1: GDP from the production side

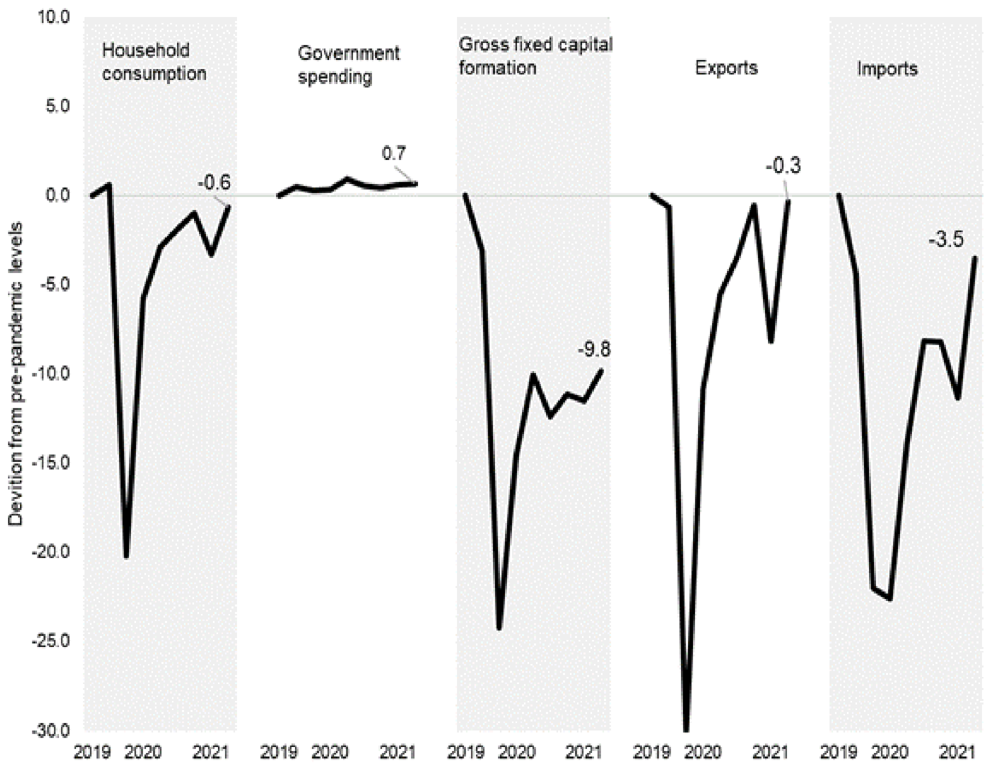


Source: Statistics South Africa

- Following a downwardly revised 1.7% q/q contraction in the third quarter (previous: -1.5% q/q).
- The fourth quarter rebound in GDP growth was largely driven by the personal services industry which contributed 0.4 percentage points to GDP growth, alongside the agricultural, manufacturing and trade industries, which each contributed 0.3 percentage points to GDP growth respectively.
- The negative contributors to growth include the mining and finance industries, with these each detracting 0.2 percentage points from total growth.
- The economic recovery remains uneven, with the secondary sector lagging significantly behind the rebound seen in the primary and tertiary sectors of the economy.

REAL GDP (FROM THE EXPENDITURE SIDE) EXPANDED BY 1.3% Q/Q SEASONALLY ADJUSTED BASIS IN THE FOURTH QUARTER OF 2021

Figure 2: Expenditure on GDP

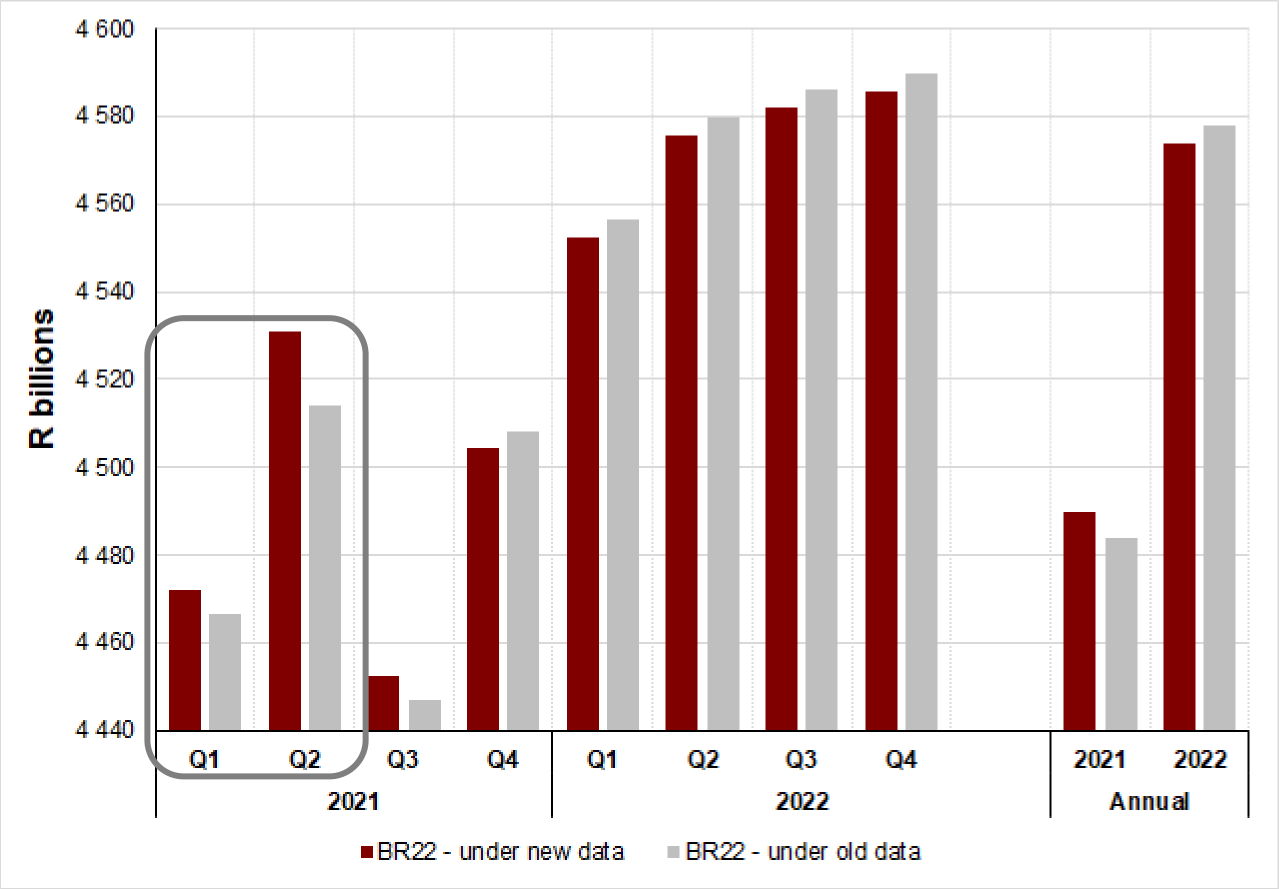


Source: Statistics South Africa

- Following a downwardly revised 1.7% q/q contraction in the third quarter (previous: -1.5% q/q).
- The rebound was primarily driven by household final consumption expenditure, which increased by 2.8% and contributed 1.8 percentage points to total growth.
- Gross fixed capital formation saw a 1.9% increase in the fourth quarter, while net exports marginally detracted from growth.
- Similar to the production side, the recovery in expenditure remains very uneven with investment remaining significantly below pre-pandemic levels.

GDP REVISIONS RESULT IN GROWTH REVISED UP SLIGHTLY HIGHER FOR 2021 FROM 4.8% AT TIME OF BUDGET 2022 TO 4.9%

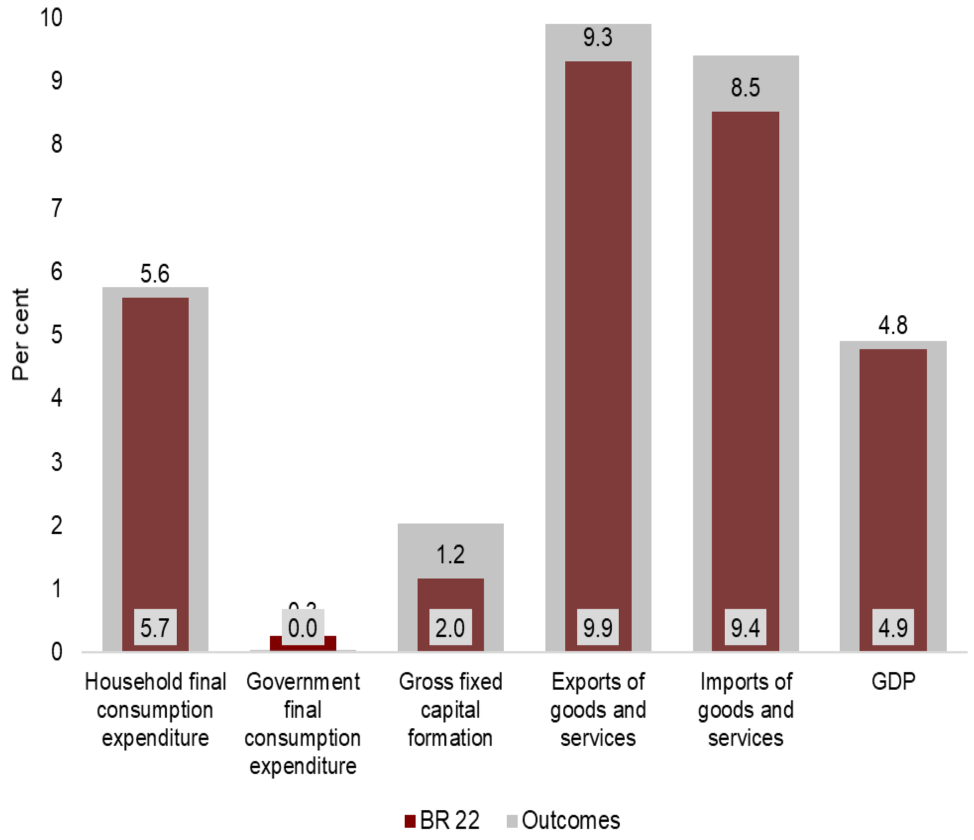
Figure 3: GDP levels (BR 2022 vs GDP outcomes)



- Growth in first half of 2021 was revised up to 7.7% y/y (previous 7.4% y/y).
- Growth in second half of 2021 registered 2.3% y/y.
  - While, a weaker-than-anticipated activity in the second half of 2021 has introduced marginal downside risk to the 2022 growth estimate published in February 2022.

IMPLICATIONS FOR THE 2022 BUDGET REVIEW GROWTH OUTLOOK

Figure 4: Comparison of 2021 actuals vs Budget Review 2022 estimate



Source: Stats SA, NT Modelling and Forecasting

- The fourth quarter GDP outcome of 1.2% is 0.2 percentage points lower than the 1.4% estimate in the Budget Review 2022.
- The largest contributors to the annual growth rate are finance (0.9 percentage points), personal services (0.8 percentage points) and manufacturing industries (0.8 percentage points), which recorded 3.7%, 5.3%, and 6.6% growth respectively for 2021.
- The fourth quarter GDP growth outcome along with a downwardly revised third quarter outcome adds downside risk to the Budget Review 2022 growth estimate.
- The realisation of emerging downside risks (notably the Russia-Ukraine war) could result in significantly higher global inflation and commodity prices.
- However, higher export commodity prices could extend the revenue windfall for longer, and support demand for South Africa's commodity exports.