The Cost of the Russia Saga

ECONOMICS | SOUTH AFRICA

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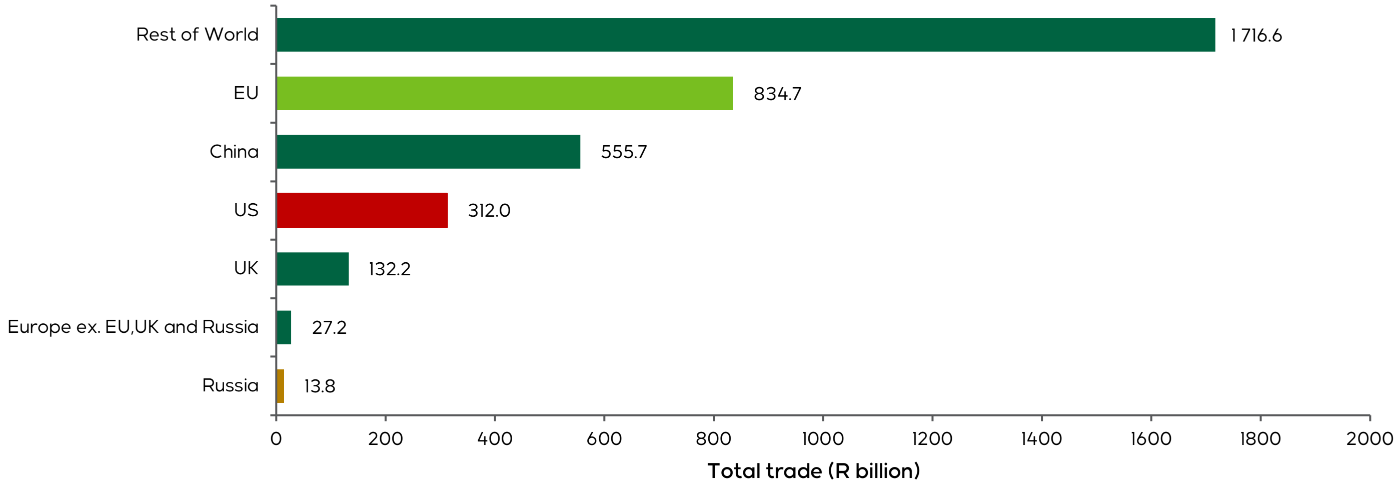
Financial stability and trade at risk as SA rubs shoulders with Russia

- The government's geopolitical spat with the US over its apparent support for Russia in its war on Ukraine has not only undermined the country's reputation, but also wreaked havoc in the financial markets, driving the rand to new record lows at a time that the country can least afford it, with the worsening electricity crisis already hurting economic activity and adding to inflationary pressures.
- Encouragingly, the US and SA have acted to de-escalate tensions after the accusations of SA arms shipment to Russia. However, the US still wants answers and awaits the results of President Ramaphosa's inquiry into the secretive visit of the Russian cargo ship, with its transponder deactivated, to Simon's Town Naval Base. The risk, therefore, remains that the US could take a harder line against SA if the inquiry shows that arms were loaded onto the Russian warship.
- SA's relationship with Russia will likely remain in the spotlight as the 15th BRICS Summit on 22-24 August in SA approaches. Since SA is a signatory to the ICC, the government must arrest the Russian president if he attends the Summit. The government appears to be seeking a 'legal' way out of executing the arrest warrant issued by the International Criminal Court (ICC) against Vladimir Putin by granting diplomatic immunity to visiting heads of state and diplomats. All eyes will remain on SA's relationship with Russia, and as a result, the risks of future economic setbacks remain high.
- The geopolitical risks will continue to weigh on the rand, with potentially harmful implications for inflation and interest rates.
- The potential economic and trade costs of damaging relations with the US would be significant. It could also extend to other US allies. If there is a complete breakdown of SA-US relations, the EU will likely follow the US. This would greatly cost the country, with most of the impact expected to come through the financial markets and global trade, with very negative impacts on economic growth and job creation.
- SA has strong trade links with both the US and EU. The EU as a bloc is our largest trading partner, while the US is our 3rd largest trading partner among individual countries after China and Germany. As it currently stands, about 25% (R59.2 billion) of SA's exports to the US benefit from both Africa Growth and Opportunity Act (AGOA) and Generalised System of Preferences (GSP), while a significant 98.7% (R429.2 billion) of exports to the EU benefit from the European Partnership Agreement (EPA). The mining, manufacturing and agricultural sectors are the main beneficiaries of these trade agreements.
- Total trade under AGOA (and GSP) and the EPA contribute 0.9% and 12.6% to the country's GDP. Total trade with Russia contributes a mere 0.2% to GDP. There is much more to lose from possibly severing relationships with the US and EU.
- SA runs wide twin deficits – current account and budget balance – equivalent to 0.5% and more than 4% of GDP respectively, and the country is reliant on foreign funding to cover these shortfalls. The current account deficit will widen as exports contract due to the effects of loadshedding, increasing the need for more foreign financing.
- In this regard, it is also worth noting that the bulk of government's debt is financed by the West and Asian investors from countries aligned with the US. If our ties with the US and the EU were to be severed, the ripple effects would extend far and wide, threatening financial stability. SA already has its plate full of issues, adding to that is not wise, not geopolitically and certainly not economically.

Chart 1: SA's total bilateral trade with the world in 2022



Source: SARS & Nedbank calculations

SA's strange choices: Acting against our own economic interests

Government has plunged the country into a damaging geopolitical situation with the US over its "friendship" with Russia, the aggressor behind the tragic war in Ukraine. While SA has officially adopted a non-aligned or neutral stance on the conflict, it has compromised this position through actively engaging with Russia, not just through diplomatic channels, but through military engagements. Pretoria allowed a sanctioned Russian cargo vessel to dock at Simon's Town Naval Base in December, engaged in a joint naval exercise off the KZN coast in February, and allowed a military aircraft that has been sanctioned for transporting arms for the Russian paramilitary Wagner Group, to land at Waterkloof Air Force Base in April. The plane landed in the middle of the night with its transponder deactivated. SA has also taken a bewildering and often contradictory array of positions over its membership of the ICC after the issuance of a warrant of arrest against Vladimir Putin for war crimes committed in Ukraine.

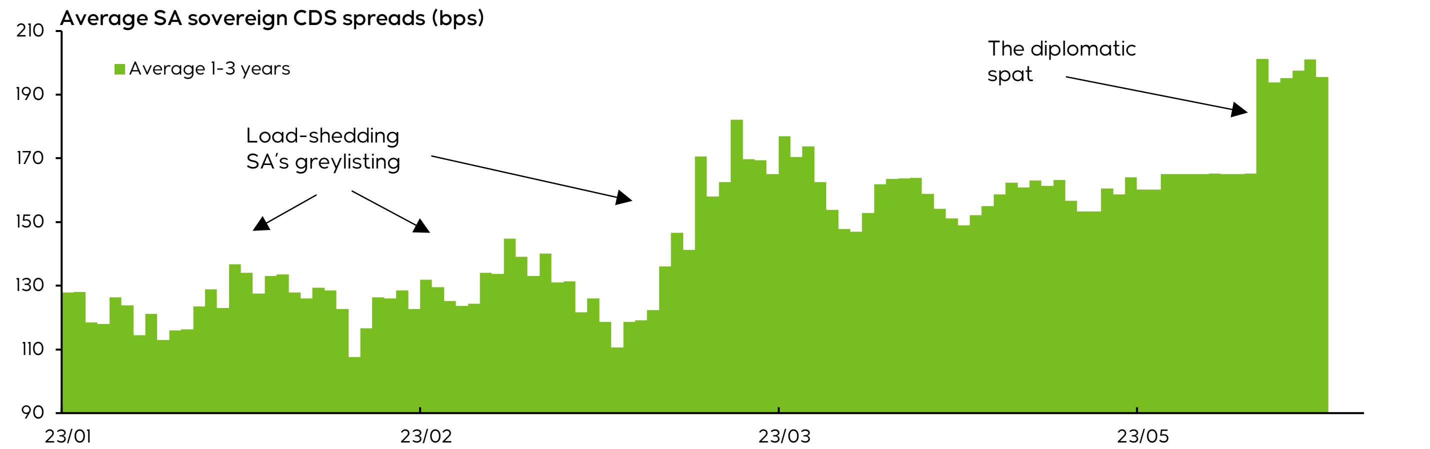
While all these events added to tensions with the US and the EU, the situation escalated dramatically over the past two weeks after the US Ambassador accused SA of selling arms to Russia in support its war on Ukraine. The US believes that the Russian cargo ship that docked at Simon's Town naval base in December picked up weapons. Pretoria denied all allegations. President Ramaphosa confirmed that there is no official record of an arms sale to Russia and instituted an inquiry to probe the allegations. The Financial Times (FT) reported that the Biden administration would prefer to address the allegations privately to avoid damaging the relationship any further. Encouragingly, both sides of the divide appear eager to de-escalate tensions. However, SA is not off the hook, as the US still wants answers and awaits the results of the inquiry.

The risk, therefore, remains that the US could take a harder line against SA. The US, the EU, and its allies imposed strict and wide-ranging sanctions on Russia for its unprovoked and brutal war on Ukraine. A key element of these sanctions includes restrictions on the supply of arms, other logistical military equipment, and parts and equipment which could be used to manufacture weapons and ammunition. The US has already warned several counties that supplying arms to Russia would be met with '*serious consequences*'. If evidence of an arms supply were found, the US would probably take punitive actions, which could range from the scrapping of preferential trade agreements to trade and investment restrictions and even outright sanctions. If these outcomes were to materialise, the government's actions would not only severely undermine its relationship with the world's largest economy and SA's 3rd largest trading partner but also inflict significant further damage on SA's already battered economy. Worst of all, the government is taking these enormous risks for the sake of an insignificant economic and trade relationship with Russia.

While attention on the Simon's Bay incident is likely to fade somewhat as the inquiry drags on, SA's relationship with Russia will remain in the spotlight as the 15th BRICS Summit on 22-24 August approaches. The government appears undecided on how to deal with the ICC warrant of arrest issued against Vladimir Putin, as he has been invited to attend the Summit in SA. Given that SA is a signatory to the ICC, the government is obliged to arrest the Russian president if he sets foot on SA territory. However, SA already once ignored an ICC arrest warrant on Sudan's Omar al-Bashir during the Zuma years. This time round the government appears to be seeking a 'legal' way out of the executing the arrest warrant, granting diplomatic immunity to visiting heads of state and diplomats. All eyes will therefore remain on SA's relationship with Russia, and as a result, the risks of future setbacks remain high.

The geopolitical storm has already inflicted significant damage on the economy. SA's apparent shift towards Russia has raised the country's risk premium further, driving the sovereign's credit default swap (CDS) spreads over US equivalents higher.

Chart 2: The Russian saga drove SA's country risk premium up sharply

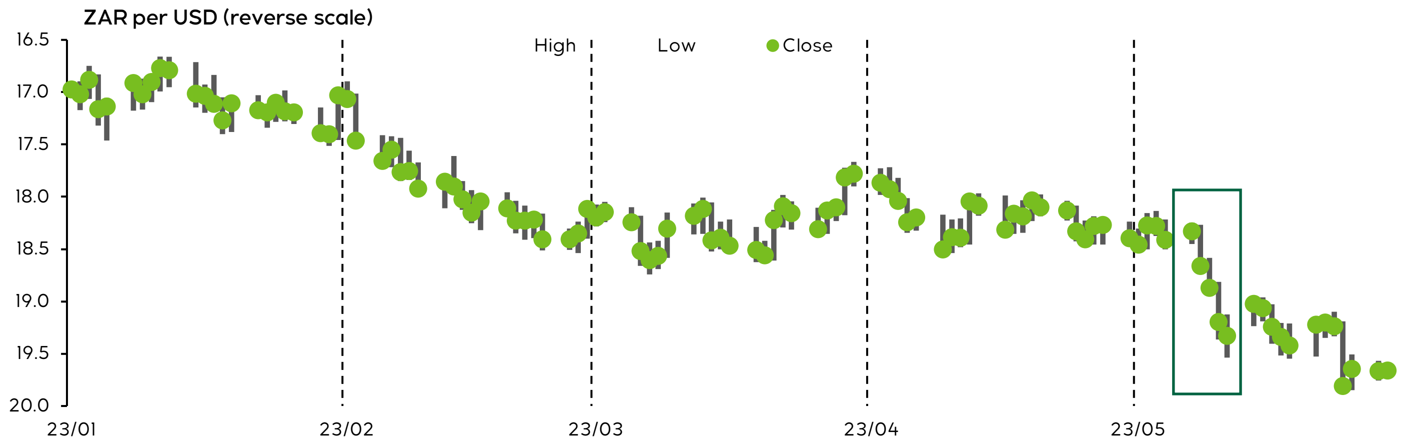


Source: Refinitiv

As investor confidence in SA imploded, the rand came under severe pressure, plunging to R19.5216 against the US dollar on 19 May after the arms-sale allegations broke and as diplomatic tensions intensified. Government's tensions with the US over Russia were the catalyst for the step-change to a lower level. Since then, the rand has depreciated even further, hitting a new record low against a resurgent US dollar of R19.8679 on 30 May before pulling back slightly to R19.76. The persistent weakness reflects the impact of a variety of forces. The markets were disappointed when their bets of a larger hike in domestic policy rates failed to materialise. At the same time, the US dollar regained some lost ground as global investors turned risk-off amid expectations US interest rates could stay higher for longer, given some stickiness in inflation and the continued economic resilience of the US economy.

May's implosion takes the rand's depreciation against the US dollar to 14% for the year to date, making it one of the worst-performing emerging market currencies this year.

Chart 3: The diplomatic storm sent the rand tumbling down the rabbit hole



Source: Refinitiv

The jump in the country's risk premium and the slide in the rand also drove up bond yields. The yield on the 10-year benchmark government bond rose to 11.33% at the end of May from 10.88% before the diplomatic storm and 10.18% at the end of April. If sustained, it will raise government's debt service costs and add to further the public sector debt burden. As the debt burden climbs, the already limited fiscal space for key socio- and economic spending priorities will diminish even further. (*See Nedbank CIB's Fixed Income Team's Insight: "The Cost to the Budget of playing Russian roulette" dated 19 May 2023*)

Table 1: The impact of rand depreciation on inflation

	Base forecast	Effect of depreciation (ppts)	New forecast
1% rand depreciation			
2023	6.111233	0.01609	6.1284
2024	4.94380	0.01147	4.9553
5% rand depreciation			
2023	6.1	0.08045	6.2
2024	4.9	0.05734	5.0
10% rand depreciation			
2023	6.1	0.16090	6.3
2024	4.9	0.11468	5.1

Source: Nedbank

The rand's renewed depreciation comes as the country battles stickier-than-expected inflation caused by surging production costs driven by the enormous cost implications of load-shedding and earlier rand weakness. These two factors are largely offsetting the benefits of global disinflation emanating from sharply lower global oil, food, and other commodity prices. In our inflation model, a 1% sustained depreciation in the rand adds 0.02 ppts to headline inflation in year one and another 0.01 ppts in year two. This means that a 5% sustained depreciation adds 0.1 ppts in both year one and two, and a 10% sustained depreciation add 0.2 ppts in year one and 0.1 ppts in year two. By adding to the rand's woes, the government is aggravating inflation, placing even greater pressure on monetary policy to compensate for the rising risk premium, stabilise capital inflows, steady the rand and counter price effects through higher interest rates than would otherwise be the case.

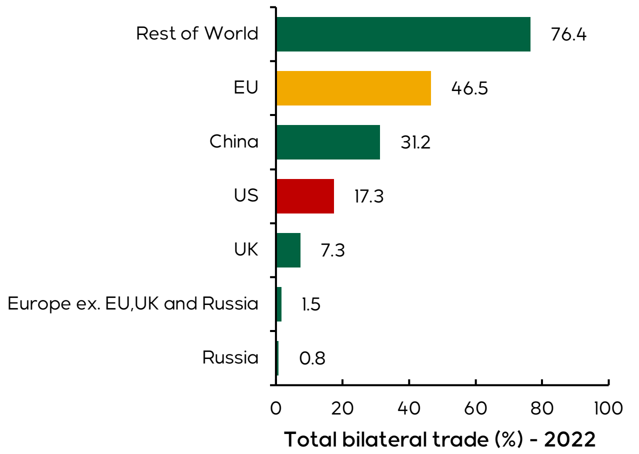
Against this background, the SARB's Monetary Policy Committee (MPC) has increased interest rates aggressively, raising the repo rate by another 125 bps so far this year. In its May Monetary Policy Statement, the SARB described the level of interest rates as '*restrictive, consistent with elevated inflation and risks*'. This brings the cumulative increase in this tightening cycle to 475 bps, taking the prime lending rate to 11.75%. Given that the rand faces further event risk from the BRICS Summit, the probability of further interest rate hikes remains high.

The aggressive rise in interest rates will worsen the financial strain on households, dampen demand for credit and raise the risk of defaults. At the same time, shrinking consumer demand and rising operating costs will continue to chip away at company profits, forcing significant rationalisation, which could entail the scrapping of investment projects, renewed wage restraint, and ultimately another wave of job losses. SA's higher risk premium due to its alienation from the US will amplify the downward spiral triggered by the escalation in load-shedding.

The potential impact of exclusion from AGOA and GSP

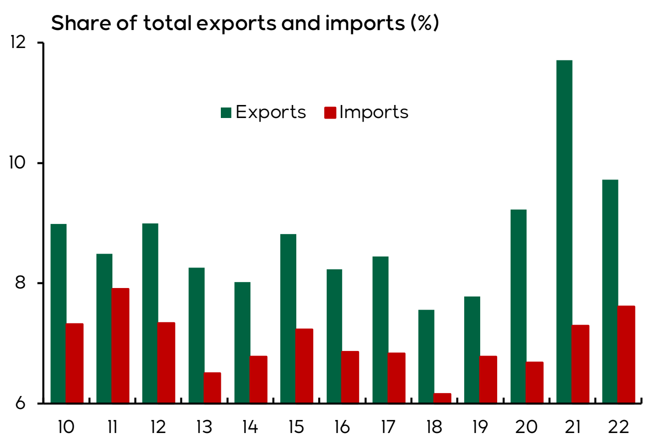
SA has benefitted from favourable trade relations with the US for years and is the largest beneficiary of the Africa Growth and Opportunity Act (AGOA). The country also enjoys additional benefits from the US under the Generalised System of Preferences (GSP). Should relations with the US continue to deteriorate due to SA's perceived support of Russia, the country could be in an extremely unfavourable position. The US could potentially take punitive actions. In its mildest form, it could be exclusion from AGOA, or in the worst-case scenario, a complete ban on trade with SA or even wider sanctions. This would be costly given SA's strong trade links with the US. The US is SA's 3rd largest trading partner, accounting for 9.7% and 7.6% of total exports and imports, respectively. At the end of 2022, this translated into R178 billion worth of exports and R133.9 billion of imports.

Chart 4: The US is SA's 3rd largest trade partner



Source: SARS & Nedbank calculations

Chart 5: The US accounts for 9.7% of SA's total exports



Source: SARS &Nedbank calculations

Ultimately, an expulsion from AGOA and GSP would entail that certain exports would not enjoy the current preferential treatment and could thus face difficulty entering the US market. This would impact approximately 25% of the country's exports to the US, amounting to about R59.2 billion, contributing almost 1% to GDP. In the worst-case scenario, that being a complete ban on trade or severe sanctions, the loss will be even more significant. Given that exports to the US account for 9.7% of total SA exports, we can then assume that this will be the total loss to our export revenue. In 2022, this was equivalent to R178 billion in export revenue. The numbers are even more dire when considering that SA's exports and imports with the US amounts to 17.3% of total trade, contributing a sizeable 4.7% to GDP.

Table 2: The value of SA's trade with the US

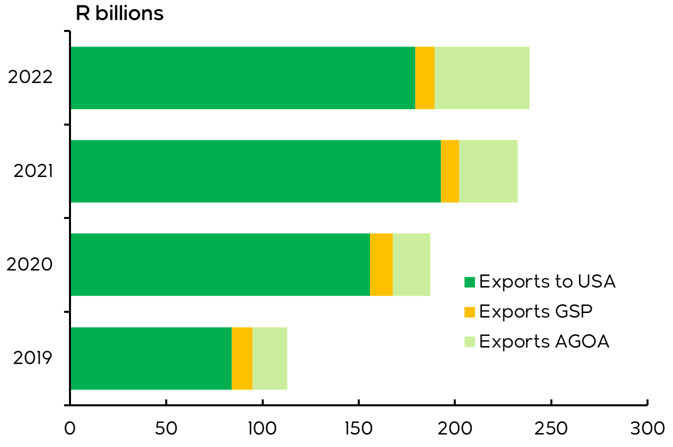
SA trade with the US		2019	2020	2021	2022
Exports (X) to US	R bn	89.4	116.2	193.1	178.0
	% of GDP	**1.6**	**2.1**	**3.1**	**2.7**
	% of total SA's exports	7.8	9.2	11.7	9.7
Imports (M) from US	R bn	83.3	72.2	96.9	134.0
	% GDP	**1.5**	**1.3**	**1.6**	**2.0**
	% of total SA's imports	6.8	6.7	7.3	7.6
Total trade	R bn	172.7	188.3	290.0	312.0
X+M	**% of GDP**	**3.1**	**3.4**	**4.7**	**4.7**
	% of total SA's trade	14.6	15.9	19.0	17.3
Benefits of trade deals					
AGOA X	R bn	18.0	19.4	30.7	49.4
	USD bn	1.2	1.2	2.1	3.0
	% GDP	**0.3**	**0.3**	**0.5**	**0.7**
	% of total X to US	16.0	10.4	13.2	20.7
	% of total SA exports	1.6	1.5	1.9	2.7
GSP X	R bn	10.9	11.8	9.3	9.8
	USD bn	0.8	0.7	0.6	0.6
	% GDP	**0.2**	**0.2**	**0.1**	**0.1**
	% of total X to US	9.7	6.3	4.0	4.1
	% of total SA imports	1.0	0.9	0.6	0.5
AGOA+GSP X	R bn	28.9	31.2	39.9	59.2
	USD bn	2.0	1.9	2.7	3.6
	% GDP	**0.5**	**0.6**	**0.6**	**0.9**
	% of total X to US	25.4	16.7	17.2	24.8
	% of total SA trade	2.5	2.5	2.4	3.2

Source: Stats SA, SARS, Tralac & Nedbank calculations

The key industries that will be affected

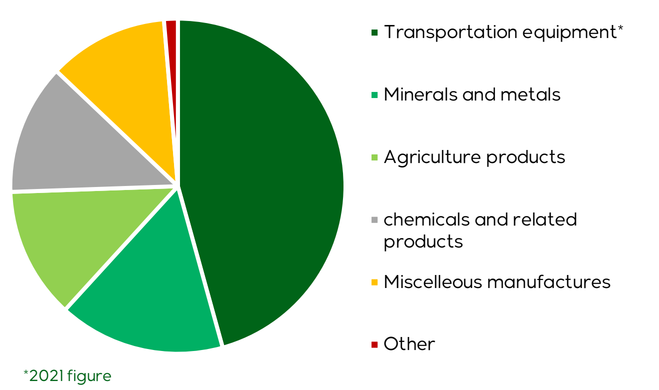
Some industries have made significant inroads into the US market under the trade agreements. Between 2019 and 2022, the proportion of exports under the trade pact increased by R30.5 billion. Exports of transportation equipment (which includes vehicles), minerals and metals, agricultural products and chemical products form the bulk of exports to the US. Even products with a much smaller market share, such as footwear, at a minuscule 0.03% of total exports, has managed to increase significantly, growing by over 500%. At a sectoral level, the manufacturing sector would be hardest hit by a trade fallout. Total manufacturing exports under AGOA amounted to 4.3% of manufacturing gross value added (GVA) or R34.7 billion in 2022. Including the benefits under GSP, this number increases to 5.3% of manufacturing's GVA or R42 billion. Agriculture and forestry exports comprised 4.5% of this sector's GVA or R7.6 billion, while mining exports amounted to 2% of mining's GVA or R9.5 billion. On aggregate, total exports under AGOA and GSP in 2022 made up 1% of total national gross value added. AGOA and GSP combined are not only a significant proportion of SA's total GVA and will have material consequences on industry, and it would also eliminate years of progress made between the two countries.

Chart 6: Total exports to the US have increased since 2019



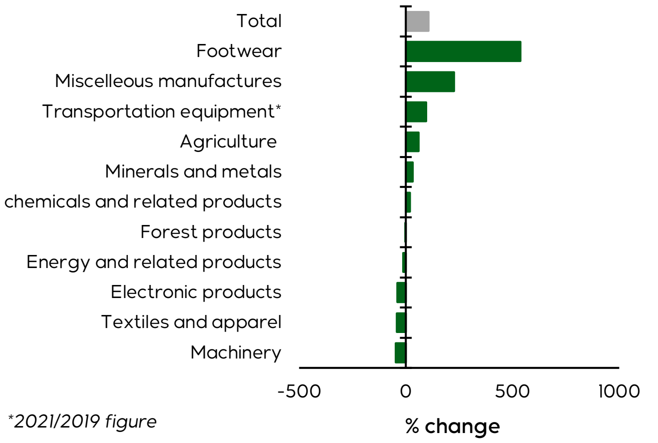
Source: SARS & Nedbank calculations

Chart 7: Industry share of exports under AGOA and GSP in 2022



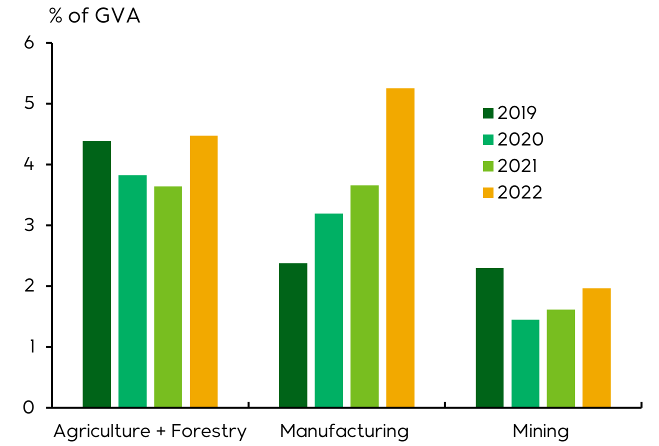
Source: SARS & Nedbank calculations

Chart 8: Change in exports between 2019-2022



Source: Tralac & Nedbank calculations

Chart 9: Industry exports as a % of gross value added

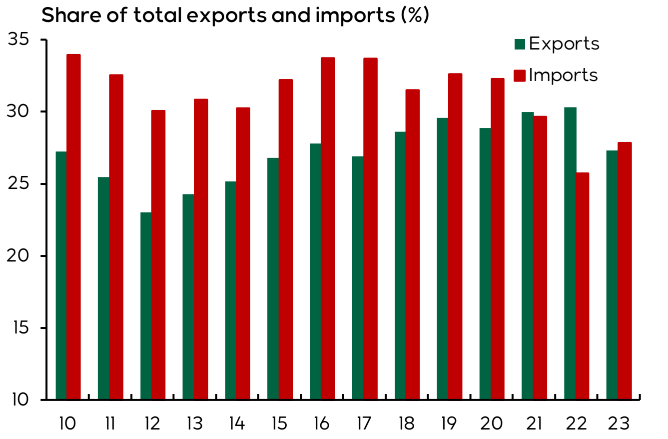


Source: Tralac & Nedbank calculations

The potential impact of exclusion from the EPA

If the US took punitive measures against SA, it would only be a matter of time until the EU and other aligned countries follow. Trade agreements between SA and European countries have been hugely beneficial to the local agriculture, mining, and manufacturing sectors. The EU remains our biggest trade and investment partner to date. It is, therefore, indisputable that the impact of a possible exclusion from the European Partnership Agreement (EPA) would significantly hurt export revenue. In 2022, EU countries accounted for 78.4% and 88.7% of SA's total exports and imports to/from Europe, respectively. The total value of exports and imports was a staggering R434.9 billion and R399.8 billion, translating to 23.7% and 22.7% of SA's total exports and imports, respectively. SA's biggest trade partners in Europe are Germany (29.5%), UK (18.5%), the Netherlands (17.5%) and Belgium (11.6%). Currently, the EU has fully or partially removed customs duties on about 98.7% of imports from SA under the EPA.

Chart 10: Europe accounts for 30.7% of SA's exports



Source: SARS & Nedbank calculations

Chart 11: The EU accounts for 23.7% of SA's total exports

Source: SARS & Nedbank calculations

Like AGOA and GSP, an expulsion from the EPA entails that SA exports will face trade barriers into the EU markets. However, unlike with the US, almost all SA's exports to the EU (98.7%) will be subject to more stringent custom requirements. In the worst-case scenario, the total loss of export revenue from the EU will equate to around R434.8 billion, 23.7% of SA's total export revenue. When considering all European countries, except Russia, the possible loss climbs to R550.3 billion, a massive 30.3% of the country's total export revenue. In terms of the contribution to nominal GDP, trade with Europe adds a significant 15% to GDP, with the EU alone accounting for 12.6% of this.

Table 3: The value of SA's trade with Europe

Europe ex. Russia		2019	2020	2021	2022
Exports (X) to Europe	R bn	334.3	357.4	488.7	550.3
	% of GDP	6.0	6.4	7.9	8.3
	% of total SA exports	29.6	28.9	30.0	30.3
Imports (M) from Europe	R bn	392.8	340.0	385.1	443.8
	% of GDP	7.0	6.1	6.2	6.7
	% of total SA imports	32.6	32.3	29.7	25.7
Total trade (X+M)	R bn	727.1	697.4	873.8	994.0
	% of GDP	13.0	12.5	14.1	15.0
	% of total SA trade	42.5	41.4	44.1	45.3
EU					
Exports (X) to EU	R bn	250.9	271.5	351.9	434.9
	% of GDP	4.5	4.9	5.7	6.6
	% of total SA exports	21.8	21.6	21.3	23.7
Imports (M) from EU	R bn	335.2	293.9	338.4	399.8
	% of GDP	6.0	5.3	5.5	6.0
	% of total SA imports	27.3	27.2	25.5	22.7
Total trade (X+M)	R bn	586.0	565.4	690.4	834.7
	% of GDP	10.4	10.2	11.1	12.6
	% of total SA trade	49.1	48.8	46.8	46.5
Russia					
Exports (X) to Russia	R bn	5.5	6.2	6.1	4.6
	% of GDP	0.1	0.1	0.1	0.1
	% of total SA exports	0.5	0.5	0.4	0.3
Imports (M) from Russia	R bn	7.7	8.6	9.2	9.2
	% of GDP	0.1	0.2	0.1	0.1
	% of total SA imports	0.6	0.8	0.7	0.5
Total trade (X+M)	R bn	13.1	14.8	15.3	13.8
	% of GDP	0.2	0.3	0.2	0.2
	% of total SA trade	1.1	1.3	1.1	0.8

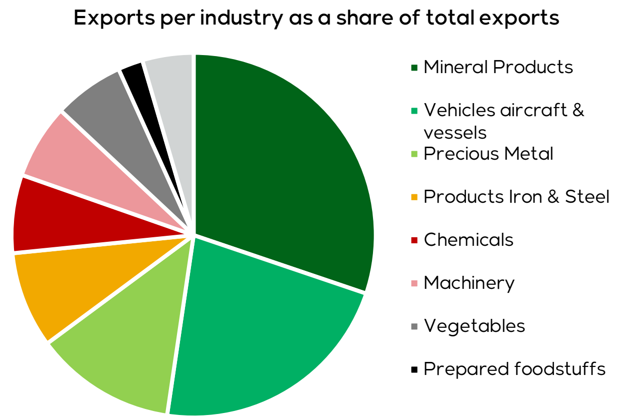
Source: SARS & Nedbank calculations

In comparison, 2022's total value of exports and imports between SA and Russia were R4.6 billion and R9.2 billion, translating to 0.3% and 0.5% of SA's total exports and imports, respectively. SA's trade with Russia has not grown significantly since 2010, indicating that SA's trade relationship with Russia has always been quite minuscule. In fact, total trade with Russia contributed a mere 0.2% to GDP in 2022.

Key industries that will be affected

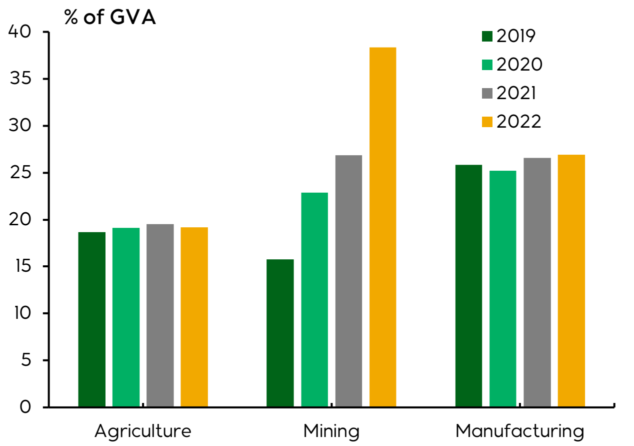
If SA loses preferential access to the EU, the impact would be even more severe. Total mining exports accounted for 38% of mining GVA in 2022, followed by manufactured goods at 26.9% and agricultural merchandise at 19.2% - together adding up to R434 billion. On a more disaggregated basis, exports of mineral products (30% of total exports in 2022), vehicles (22%) and precious metals (9%) accounted for 65% of SA's total exports to the EU, and therefore these industries stand to lose most from any adverse trade developments.

Chart 12: Exports per industry as a share of total exports



Source: Tralac & Nedbank calculations

Chart 13: Industry exports as a % of GVA



Source: Tralac & Nedbank calculations

Table 4: SA exports to the EU and USA (under AGOA and GSP)

EU Trade 2022				AGOA+GSP 2022				
Industry	% of GVA	R bn	% of total exports	Industry	% GVA	R bn	% of industry exports	% of total exports
Agriculture	19.2	33.0	7.6	**Agriculture + Forestry**	4.5	7.6		
Live animals		4.1	0.9	Agriculture products			71.3	12.69
Vegetables		27.2	6.3	Forest products			23.5	0.22
Animal or vegetable fats		1.4	0.3					
Mining	38.3	185.8	42.7	**Mining**	2.0			
Mineral products		131.3	30.2	Minerals and metals		9.5	6.6	16.08
Precious metals		54.5	12.5					
Manufacturing	26.9	215.0	49.4	**Manufacturing**	5.3			
Chemicals		30.2	6.9	Chemicals and related products		7.5	49.9	12.62
Products Iron & Steel		37.1	8.5	Energy and related products		0.2	9.4	0.28
Machinery		28.8	6.6	Other		0.3	47.7	0.57
Vehicles aircraft & vessels*		82.7	23.0	Transportation equipment*		14.0	91.0	35.00
Other		22.9	5.3	Electronic products		0.2	9.7	0.27
				Miscelleous manufactures		6.9	25.8	11.59

*2021 figure

Source: Tralac & Nedbank calculations

In the worst-case scenario, where both the USA and EU withdraw from their respective trade deals, R443 billion worth of exports will be placed on the line. The mining sector would be hurt the most, with trade in 2022 at 40% of GVA. Manufacturing would follow, where the vehicle industry would suffer terribly. In 2022, SA exported R110 billion worth of transportation equipment under the trade agreements.

Overall trade implications and conclusions

Government's perceived support of Russia has compromised SA's neutral stance on the conflict between Russia and Ukraine. It has already hurt the economy and any further escalation could permanently fracture or break relations with our largest trading partners, with potentially severe consequences. It is worth remembering that the bulk of government's bonds are held by the West and Asian investors from countries aligned with the US. If our ties with the US and the EU were to be severed, the ripple effects would extend far and wide, threatening economic prospects and financial stability. Souring relations with the US and the EU will cost us much more than what we gain in trade from Russia. The US and EU combined account for 33.2% of SA's export revenue, while Russia accounts for a mere 0.3%. Severed relations with the West will hit the manufacturing, mining, and agricultural sectors, weighing on profits, impacting employment and creeping into other parts of the domestic economy. SA has its plate full of issues, adding to that is not wise, not geopolitically and certainly not economically.

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