



WHAT IF ... SOUTH AFRICA 'DOES A BRAZIL'?

Political scenarios in a time of economic crisis

November 2016

SUMMARY

Brazil continues to reel from a combined political and economic crisis that saw the country downgraded to junk status by the ratings agencies and its economic growth fall to -4% earlier this year. No one predicted the dramatic downward spiral. Could something similar happen in South Africa? The contextual conditions bear a striking resemblance. While Pravin Gordhan heroically seeks to steady the ship and implement much-needed reforms against an increasingly rogue President, it would be prudent to consider what might happen if he fails. What if SA gets downgraded in December and its economy were to shrink at the rate Brazil's has? What would the political consequences be? What would policy-makers do? What would happen next?

This report asks the question 'what if South Africa does a Brazil'? This is not a predication that SA is going to experience a crisis of Brazil proportions. If anything, it is somewhat more likely that she will not. But the chances of a deep economic contraction coupled with a serious political crisis in SA are greater than zero and, in all likelihood, rising - given the series of events since President Zuma's '9/12' decision to fire Finance Minister Nene. It is, therefore, worth thinking about how such a crisis might play out here.

The social and economic consequences would be dire. There would also be some very serious political ramifications. This report explains why and sets out three possible scenarios in response to the country's public finances being put under unprecedented pressure - some very difficult choices would have to be made about what areas of public spending should be cut, whether taxes should rise or if government would seek to borrow more, or whether it would resort to printing money.

Since the key parts of President Zuma's political constituency all rely, in different ways, on expanding public finances, his support base would be put under huge pressure. Something would have to give, and there would be dramatic consequences that could break the current mould of South Africa's democratic politics.

We anticipate two broad scenarios: one in which the President retains power and adopts policies that ameliorate the effect of the recession on his favoured groups (Revenge of the Sith), another where he attempts to do this, but the economic pain leads to his replacement. In this instance, there are two further sub-scenarios: the President's existing coalition retains power but replaces him (The Phantom Menace), and another where it loses power to a coalition of rival constituencies (A New Dawn).

Finally, the report identifies some of the key inflexion points that will provide real clues as to the future direction of travel.

What if ... South Africa does a Brazil?

SA's economy has slowed to a standstill. But even at 0% growth, it is growing at four percentage points a year faster than Brazil's -4% earlier this year. Nobody predicted Brazil's economic collapse even three years ago, and now it is part of an overlapping series of crises that has darkened the country's prospects and sent it spiralling into political tumult. SA has avoided a downgrade to junk status by the ratings agencies... for now. But what if SA gets downgraded in December and its economy shrank at the rate Brazil's has? What would the political consequences be? What would policy-makers do? What would happen next?

THE KEY ELEMENTS OF BRAZIL'S CRISIS

Brazil's crisis combines three overlapping, mutually reinforcing elements:

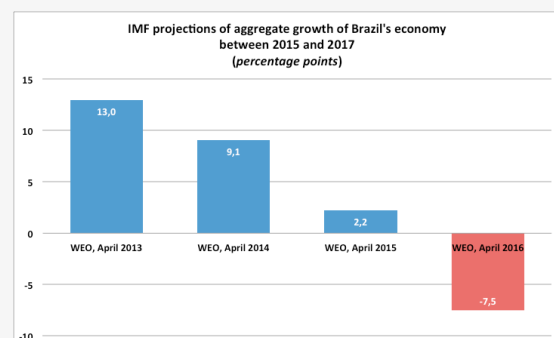
- A dramatic **economic slowdown** that has its roots in the unsustainable ways Brazil responded to the windfall of the (now-busted) global commodities boom, leading to ratings downgrades (see box).
- A **massive loss of credibility on fiscal policy** that is a combination of falling tax revenues (resulting from a contracting economy), and high levels of rigidity in public spending plans resulting in the Brazilian government's repeatedly missing its deficit targets. The loss of fiscal credibility was worsened by **deliberate acts of concealment** in the run up to presidential elections in 2014.
- A **crisis in political leadership** due primarily to a mega corruption scandal that has engulfed large segments of the political elite along with a number of para-statal and business leaders, and which has paralysed policy-making.

WHY A BRAZIL-STYLE CRISIS COULD HAPPEN IN SA

- Economic growth that has stagnated
- Tightening fiscal conditions as falling tax revenues meet rigid spending plans that are driven by large personnel and social benefits costs;
- Rapidly rising debt and debt costs, leading inexorably to a downgrade; and
- Corruption-related political crises gripping the highest offices in government.

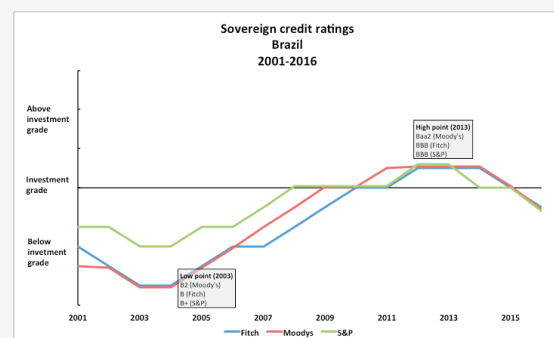
NOBODY SAW BRAZIL'S CRISIS COMING

As recently as April 2013, the IMF, in its World Economic Outlook, projected that the Brazilian economy would grow by a total of 13% between 2015 and 2017 (i.e. at an average of over 4% a year). A year later, the IMF thought Brazil would grow by over 9% over that period. Its most recent projection expects Brazil's GDP in 2017 to be nearly 8% lower than it was in 2014, a swing of 20 points in just three years.



Source: World Economic Outlook, IMF (various years)

The change in Brazil's prospects has led to ratings downgrades back into junk territory.



Source: Authors

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The immediate consequences of collapsing growth would be felt in hundreds of thousands of job losses (see box), a large increase in bankruptcies, and collapsing tax revenues. The economic consequences would be severe, but the political ramifications would be potentially even more serious and dramatic.

THE POLITICAL PRESSURE POINTS

The immediate political impact of a steep fall in GDP would be:

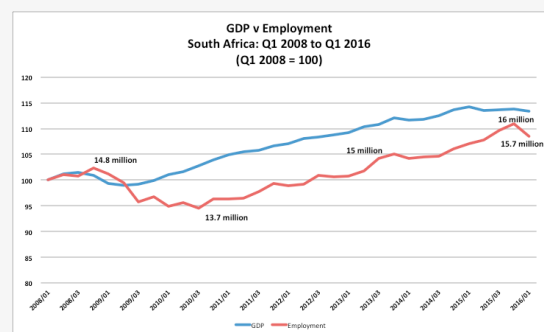
- Considerable numbers of protests in and around the cities, with focal points in and around firms that were retrenching large numbers of staff;
- Public violence and attacks on public and private property, leading to significant numbers of dangerous police/civilian stand-offs, similar to those that animated the recent student unrest;
- Pressures on the state to bail out failing business (including, possibly, over-extended banks and lenders), and collapsing tax revenues.¹
- Some cases of confrontation between different groups of civilians if supporters of politicians mobilise in response to protests against those politicians (e.g. the July-2016 Tshwane violence organised in response to a decision to replace the incumbent mayoral candidate with another, and the continuing killings of ANC members in KZN); and
- Ever-rising doubts within the broad ANC-led Alliance about the capacity of incumbents to resolve the economic crisis and absorb the resulting socio-economic stress, leading to further fracturing of the ruling political elite. The Zuma Presidency is already fragmenting the Alliance with the SACP and key COSATU affiliates deserting him.

The collapse would, in other words, drive up demands on public resources at precisely the moment when the state becomes less able to meet them. It would also make determined and coordinated political action harder to achieve as internal conflict worsened.

i. Tax buoyancy – the relationship between the rate of growth of tax revenues and GDP – has averaged 1.1 since 1994/95, which means that tax revenues typically grow at about 10% faster than the rate of growth of nominal GDP. If the SA economy grew at -4% with inflation at 6%, nominal GDP would rise by 2% and tax revenues would likely rise by about 2.2%. That would be 3.8% slower than the rate of inflation, necessitating real cuts in spending.

A SHRINKING ECONOMY WOULD BE A DISASTER FOR EMPLOYMENT

During the global financial crisis, the SA economy shrank by about 2.5% between the third quarter of 2008 and the second quarter of 2009, before it began to start growing again. Job losses began in the in the first quarter of 2009 and continued until well into 2010, by which point about a million fewer South Africans were working than had been working at the end of 2008. And this was despite preparations for the World Cup helping to create jobs. This gives some indication of the potential employment catastrophe that the economy's shrinking by 4% would entail. Another indication is more recent: the shrinking of the economy by 0.3% in 2016 led to the net loss of 355,000 jobs between Q4 of 2015 and Q1 of 2016.



Public finance under pressure: the big dilemmas

When an economy contracts drastically in the way Brazil's has, the consequences are profound but a government's options in response are limited. **Some very difficult choices would have to be made about what areas of public spending should be cut, whether taxes should rise or if government would seek to borrow more, or resort to printing money.**

Critically, there are important differences between these options in terms of who bears the costs and when. In thinking about how a Zuma government might choose between these options, it's necessary to think about the costs of each, who bears those costs, and whether the

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costs are to be incurred in the short, medium or long term. Since negative growth would reduce the ability of the state to repay its existing debts, any new borrowing would likely be extremely expensive, especially if capital markets did not see concrete action to cut spending elsewhere. It would fall to the Minister of Finance to advise Cabinet and the President of the limited options available and the necessary and acute political trade-offs.

These choices will be unwelcome and would be met by resistance from other ministers whose capacity to maintain law and order, rebuild damaged property, reduce poverty, support businesses, provide education and healthcare, etc. would be undermined by any cuts to spending. In turn, President Zuma's leadership would be put under unprecedented pressure in resolving the dilemmas.

So how would Zuma respond?

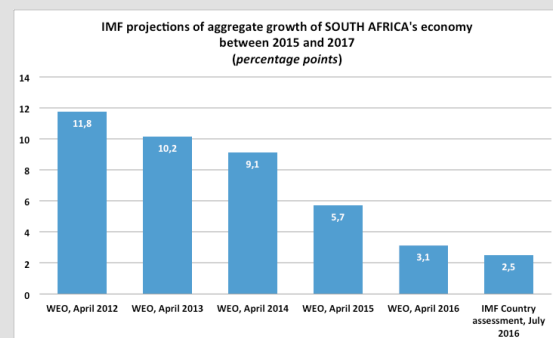
President Zuma's goals, like those of all politicians whose politics are largely transactional, are to stay in power, protect his interests and those of his family and closest cronies, and to manage his succession. In his case, the urgency of this is accentuated by the potential that a loss of power might be followed by a loss of wealth and even his personal liberty. In order to secure his main goal, he has assembled a coalition of constituencies who believe that he can better protect their interests than any plausible alternative. This comprises of:

- Public servants, including political deployees in state owned enterprises
- The rural poor
- Some ANC gatekeepers and provincial barons responsible for mobilising voters and protecting their own interests and those of other insiders.

The common theme linking the members of these constituencies is a shared reliance on government spending and, therefore, on expanding government finances.

SOUTH AFRICA'S RAPIDLY DIMINISHING PROSPECTS

While no-one is projecting a deep and sustained recession at this point, SA's short-term growth prospects have dimmed quickly. As recently as April 2012, the IMF expected SA's aggregate growth between 2015 and 2017 to be nearly 12%. By the release on 7 July 2016 of the latest IMF Country Assessment, the total projected growth between 2015 and 2017 was 2.5%, or more than 9 percentage points lower.



Source: IMF reports

An economic crisis would threaten their interests, and it is to be expected that they would pressure their leaders to adopt policies that (at least) maintained current public sector spending plans, even if this was at the expense of higher taxes and/or more (and more expensive) borrowing.

Given the transactional character of President Zuma's approach to policy-making, he would likely prefer an approach to dealing with the crisis with the highest short-term gains for his core constituencies irrespective of the long-term implications and economic risks. There would be significant ripple effects on intra-ANC politics, especially the succession battle and the on-going struggle for dominance within the organisation between the nationalists and authoritarian populists on the one hand, and the 'sensible left'/social democratic moderates on the other.

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HOW DOES THIS PLAY OUT?

We envisage two broad scenarios for how a Brazil-style recession would affect SA politics: one in which the President retains power and adopts policies that ameliorate the effect of the recession on his favoured groups (*Revenge of the Sith*), another where he attempts to do this, but the economic pain leads to his replacement. In this instance, there are two further sub-scenarios: the President's existing coalition retains power but replaces him (*The Phantom Menace*), another where it loses power to a coalition of rival constituencies (*A New Dawn*).

Scenario One: Revenge of the Sith

It is likely that initial responses to a steep recession would be a combination of (i) raising taxes and (ii) permitting the budget deficit to expand while (iii) promising to reduce spending in the medium and long terms. Spending cuts in the short term would be modest and effected by (a) slowing the rate of increase in social security spending, (b) reducing the number of civil servants being hired (complemented by a likely freeze on appointments), but without significant retrenchments. This strategy – which is basically an ‘enhanced’ version of the present approach – in the continued absence of growth is unlikely to succeed for very long without a rapid increase in the cost of debt, rising inflation and interest rates, and on-going public protests. As in Brazil, the absence of a credible path to public sector solvency will reduce the stimulatory effects of sustained public spending as households’ incomes contract and firms reduce investment. The result will be a slow-burning crisis that will eat away at government’s credibility and legitimacy, generating more and more protest. Pressures on the ANC will mount, leading to harsher security responses, but the internal opposition will not be sufficiently organised to overcome incumbents. The best that could be hoped for would be grim: rising poverty, increasingly severe policing of opposition, and a stalemate in policy-making so the reforms needed to spur economic growth in the medium and long term will not be made. From the President’s point of view, however, this would be the best possible outcome as he would be able to see out his term, manage

succession and reinforce his allies in the security establishment.

Scenario Two: The Phantom Menace

This scenario is similar to the first, with the exception that the coalition that supports the President comes to the conclusion that its interests would be better served by someone else, and seeks to replace President Zuma with someone who would enact similar policies, but who has less baggage. It is likely that achieving this will not be possible until there is a ‘trigger event’ of some kind: perhaps a major corporate collapse leading to mass retrenchments, a Marikana-style incident at a student or labour protest, or the uncovering of a new corruption scandal involving the President or his immediate circle. In these circumstances, a challenger might emerge from the unions and/or a rural province who promises to protect workers from retrenchments, maintain high levels of public spending, and pump money into the economy. S/he might also commit himself to popular policies – land reform, asset appropriation, wealth taxes – aimed at accelerated redistribution. Given the mechanics of the ANC’s constitution, replacing an incumbent would be more easily effected through the NEC than through an elective conference, but either way there would be high risks of severe internal conflict, and even a potential split in the party.

Scenario Three: A New Dawn

In this scenario, internal pressures in the ANC fracture and weaken the existing Zuma coalition, strengthening the hand of leaders representing a different set of constituencies. This scenario is most plausible under maximum economic stress resulting in a shared set of concerns by largely urban, middle class and vocal, if unorganised, segments of society whose interests are more closely aligned with the performance of the private sector rather than the level of public spending. They would feel the brunt of an economic contraction most directly and deeply, which may well force them out of their comfort zones. They have no choice but to resist the direction of travel and to try and arrest the downward spiral by supporting new political leadership; waiting for Zuma’s

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term to come to an end organically is no longer an option.. Now encouraged to act as a result of the local government election losses of city hall power, a broad coalition led by the Gauteng ANC and supported by key members of Cabinet, along with the SACP, could form a formidable alternative to take the ANC to the 2019 elections more confident of victory, determined also to rebuild the broken social contract of the 1990s. It would nevertheless need to straddle a tight line between austerity, tax reforms and maintaining social expenditure to protect the most vulnerable whilst simultaneously stimulating the much needed economic growth, and responding to the needs of an anxious middle class and highly sceptical corporate leaders.

INFLEXION POINTS

A fraught national gathering of the ANC

The Public Protector's 'State of Capture' report, and the deepening of the cross-sectoral calls for Zuma's resignation including civil society initiatives such as the Save South Africa campaign, has put Zuma on the ropes and means that his leadership is likely to be an issue of intense scrutiny at the next NEC meeting of the ANC at the end of November (25-27th). It provides an opportunity to highlight the burden that Zuma brings to the ANC to those within who are now emboldened to challenge him. Zuma, on the other hand, will seek to continue to lay the blame at the door of the Gauteng ANC and other 'dissidents'. In a 'holding move' Zuma was able to rein in the parliamentary ANC in the 'No Confidence' motion against him last week. However, if the sands shift significantly within the ANC, there is the potential to tip the balance of forces within the ANC in the succession race.

Economic Calendar

Finance minister Pravin Gordhan performed another balancing act in the Medium Term Budget Policy Statement (MTBPS) on 26 October, –as he sought to persuade the ratings agencies that he is navigating the

right path to economic growth and fiscal stability, and that he is making solid progress with his reform package. Without firm support from President Zuma, however, especially in tackling the governance failures in state owned companies, rationalising them and disposing of non-core assets, and enhancing labour market flexibility, Gordhan's prospects of success are severely constrained and the likelihood of a downgrade is increased. It is clear that with the downgrade decision a matter of weeks away, Gordhan is under huge pressure to show sufficient progress on all fronts – efforts that have been recklessly undermined by the decision of the National Director of Public Prosecutions, Shaun Abrahams, to proceed with the prosecution of Gordhan on theft and fraud charges on 11 October – only to withdraw the charges three weeks later.

Increasingly Assertive Business Leadership

As the cross-sector clamour for Zuma to go grows, so too does the assertiveness of business leadership (as evidenced by amongst other things, the CEO initiative) – finally putting aside its timidity to offer strong comment on political affairs, such as the attacks on Gordhan, the capture of state institutions and ministers by the Guptas, and the need for real action to structurally reform the economy to promote significant growth – which positions business to play an even bolder political role in the event of a Brazil-type crisis and downward spiral.

Ructions at the Treasury or Reserve Bank

A downgrade by the ratings agencies in December may pave the way for Zuma to fire Pravin Gordhan, blaming him for this outcome. This may lead to an exodus of experienced personnel at the Treasury and the Reserve Bank, which will further undermine economic stability.

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Security clampdown is implemented

Should protests against Zuma's policies following the economic crisis escalate, the security establishment may impose a crackdown of protest leaders, detaining them on spurious charges, etc., and even deploying the army to maintain order. This may be accompanied by a clampdown on media freedom to prevent reporting the protests, giving rise to serious concerns about civil liberties in modern South Africa.

NUM abandons Cosatu and AMCU expands across the economy

A failure by COSATU-aligned unions to secure deals as good as those by AMCU and NUMSA may lead to a further exodus of unions from the COSATU fold, creating conditions for more militant demands from workers even as the economy is squeezed.

As a dramatic political year draws to a close, political uncertainty is on the rise, and the pathway towards a major political and economic crisis becomes clearer, the possibility of a Brazil-type crisis should not be ignored.

- i. This is not a predication that SA is necessarily going to experience a crisis of Brazil proportions. If anything, it is somewhat more likely that she will not. But the chances of a deep economic contraction coupled with a serious political crisis in SA are not certainly not zero, and are looking increasingly more rather than less likely given the events of the past nine months starting with President Zuma's '9/12' decision to fire Finance Minister Nene, and it is worth thinking about how such a crisis might play out here.
- ii. Tax buoyancy – the relationship between the rate of growth of tax revenues and GDP – has averaged 1.1 since 1994/95, which means that tax revenues typically grow at about 10% faster than the rate of growth of nominal GDP. If the SA economy grew at -4% with inflation at 6%, nominal GDP would rise by 2% and tax revenues would likely rise by about 2.2%. That would be 3.8% slower than the rate of inflation, necessitating real cuts in spending.

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Tel (SA): +27 73 158 5736 / (UK): +44 7748 642 409

Email: info@thepaternostergroup.com

Written and edited by Richard Calland, Ian Farmer and Lawson Naidoo, in collaboration with Antony Altbeker

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