

The global economic crisis and its impact on South Africa and the country's mining industry

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Introduction

The purpose of this briefing note is, firstly, to provide a brief overview of the impact of the global financial crisis on South Africa and the country's mining industry in particular. Secondly, the note will focus on measures that South African stakeholders need to consider in order to ride out the current crisis and in order to prepare the country for the next global economic upturn.

Defining the global financial crisis

During 1999 the Clinton administration in the United States (US) placed political pressure on Fannie Mae and Freddie Mac (two quasi public-sector mortgage lending institutions) to start lending to low- and moderate-income households. The Clinton administration's objective was to expand access to housing for poorer households. This pressure also fed through into the commercial financial sector. In essence, the pressure to lend to poorer households implied that financial institutions would assume greater levels of risk. During 'flush' economic periods when asset prices (such as housing and equity prices) are rising, there are more limited risks to the lending banks. During periods of 'bear' market conditions, declining asset values would elevate the risk to banks significantly. In particular, when property prices fall below the value of the mortgage loan provided to the poorer household (i.e., a move into negative equity), the likelihood of that poorer family sustaining debt repayments diminishes significantly, resulting in rising foreclosure rates. Under normal financial and prudential regulation banks are generally required to sustain a portion of depositors' capital to loans. Financial institutions, with the best and the brightest, of course, went into 'innovation overdrive' to try to mitigate the risks of lending to low-income households. The loans to low-income households, the so-called sub-prime mortgages were then securitised, packaged as collateralised debt obligations (CDOs) and on-sold to various investors. This was also another way of taking the loans off the balance sheets of banks, to ensure that these financial institutions remained within the prudential requirements. The challenge is that the underlying debt remained to the banks.

During 2004 to 2006 US interest rates rose from 1 per cent to 5,35 per cent and the US housing market began to take strain. Falling house prices and rising interest rates led to increasing numbers of people who could not repay

their mortgages. Investors suffered losses, making them reluctant to take on more CDOs. Credit markets froze as banks became reluctant to lend to one another, not knowing how many bad loans could be on their rivals' books. Interbank lending rates spiked. Investors in banks withdrew their equity and depositors tried to withdraw their cash deposits, resulting in significant solvency and liquidity problems for the exposed banks. These problems rapidly spiralled out of control into a crisis of confidence in the banks and in the credit markets. Consumers in the US were hit hard by rapidly escalating fuel and food prices, the higher cost of debt, and the inability to obtain credit retreat from the consumer markets, forcing a significant slowdown in the US economy (two-thirds of which is driven by household expenditure).

The impact of the sub-prime mortgage crisis was then quickly shown to have implications beyond the US. Losses were felt by investment banks as far afield as Australia and Europe. Firms cancelled sales of bonds worth billions of dollars, citing market conditions, and consumers in these markets followed the US example. By April 2008 the US Treasury and US Federal Reserve Bank had to bail out two financial institutions as the 'credit freeze' gripped their financial system. Like a pack of dominoes, most banks with large sub-prime exposures joined the solvency and liquidity fracas. As liquidity issues became more challenging, investors began to withdraw funds from emerging markets in a so-called flight to quality as risk aversion set in. This further exacerbated the freeze in global credit markets and resulted in further significant declines in all stock markets. The freezing of global credit markets and the sudden significant slowdown in the large industrialised economies quickly translated into a number of country-specific rescue packages being announced as governments attempted to restore some confidence back into the financial system by helping with solvency (cash injections and the purchase of equity) and liquidity (by reducing interest rates and guaranteeing deposits).

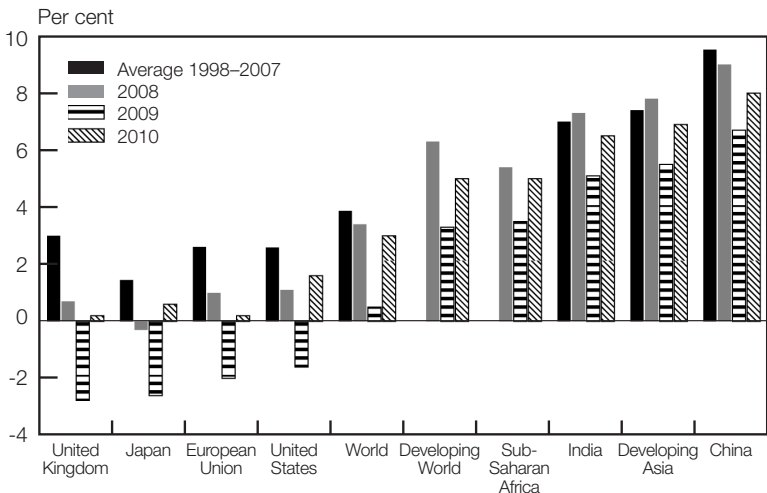
Impact of the global financial crisis on the world economy

As a result of the sub-prime crisis, the world's 15 top banks have seen their market capitalisations fall from US\$1,7 trillion in the second quarter of 2007 to US\$500 billion by 20 January 2009 (JPMorgan Eastern Europe, Middle East, Africa (EEMEA) team), a decline of two-thirds. Current estimates (Standard & Poor's, 2008) suggest that some US\$25 trillion in asset values (share prices and property values) has been wiped out at the global level, due to the unwinding of the leverage created by the global sub-prime financial crisis. This means that the approximate gross domestic product (GDP) of both the European Union and the US has been wiped out in one year – and not surprisingly consumers in these key markets have run for cover after experiencing a significant decline in

personal wealth. Coupled with consumers cutting back on purchases in the 12 months to November 2008, some 2,6 million Americans lost their jobs; the biggest decline in employment since World War II.

The unwinding of the sub-prime mortgage market, and the significant impact on household and corporate wealth have thus affected the demand side of many of the world's largest economies. The result has been that the International Monetary Fund (IMF) and the World Bank downgraded their economic growth forecasts twice during the second half of 2008. In the *Global Economic Outlook* published by the World Bank in November 2008, the world's economic growth rate is expected to slow to only 0,9 per cent in 2009 and world trade growth is expected to decline by 2 per cent; the first such decline since 1990. The situation is expected to remain volatile in the short term and further downgrades to the growth picture are possible.

Figure 1: Economic growth rates in key markets



The world's three largest economies (US, European Union and Japan) are expected to have negative economic growth rates in 2009 and overall global economic growth is expected to decline to 0,5 per cent in 2009 from 3,7 per cent in 2008.

Short-term prognosis

While the risk of moving into a full-blown depression is evident (small), the increasingly co-ordinated reflationary efforts of the world's governments

and central bankers (via recapitalising banks, guaranteeing deposits, reducing interest rates and through countercyclical fiscal policies) should overcome the deflationary effects of the impact that declining asset prices and the global financial crisis have had on global demand (consumers and companies). In the *short term the news is going to remain negative* as there has been a significant correction in consumer spending in most developed markets and this will feed through into recessions in most advanced economies, and has already affected the investment and export sectors of most developing economies. Global economic growth is expected to slow considerably from 2,5 per cent in 2008 to about 0,9 per cent in 2009, with a modest recovery expected in 2010. Advanced economies are expected to grow at -0,1 per cent in 2009 compared with 1,3 per cent growth in 2008, and developing country growth is expected to slow considerably from 6,3 per cent in 2008 to about 4,5 per cent in 2009. Global trade growth is expecting its first decline in 18 years of -2,1 per cent, which shows the seriousness of the contraction in demand.

The amount of capital available (and flowing) to developing countries in 2009 at about US\$500 billion is half of the 2008 level – and the costs of getting credit have risen considerably (6 to 10 percentage point spread between emerging-market commercial bonds and the US commercial bond market rates). Despite the weakness in the US economy and the fact that the sub-prime crisis emerged in the US, the US dollar has strengthened as investors sought safe-haven status in the US Treasury bill market. The significant depreciation of many currencies against the dollar (caused by this flight of capital and increasing risk aversion) has resulted in many developing countries going into default on their external debts, and thus having to seek out IMF stabilisation packages. At this stage, all indicators seem to be pointing towards a very challenging 2009 as countries (developed and developing) deal with the contraction in global demand and the lack of availability of credit for trade and investment. *Yes, global growth will be lower, but much of the tempo of the recovery will be determined by the pace at which credit markets unfreeze* (due to stimulus programmes, lower interest rates and, hopefully, some improvement in confidence) to enable a pick-up in trade and investment financing. However, the picture does not imply a global recession at this stage.

Possible downside risks

But there are downside risks, which may feed through into pushing the current environment into a possible global depression. A 'depression' is a sustained, long downturn in one or more economies. It is more severe than a recession, which is seen as a normal downturn in the business cycle. If the reflationary efforts of governments and central banks do not unfreeze global credit markets, the ability of countries to trade and for investment to be financed will be severely challenged, which may result

in a prolonged contraction in demand. Limited availability of credit would mean no growth in lending and no growth in investment or demand.

However, the risks may well be more acute at the political level. Already the global financial crisis is spilling over into the streets in countries such as Latvia, where the economic downturn caused by the financial crisis has been severe. In a country such as China, which has to accommodate the urbanisation of 10 to 15 million people annually, the risk of political retreat away from globalisation is a serious one. China's growth rate slowed to 6,8 per cent by the fourth quarter of 2008, and this is below the 7 per cent minimum growth rate that is needed to create employment for the large numbers of people urbanising – so the risks of upheaval have increased.

The last thing the world needs right now is a shift back to a polarised world characterised by trade protectionism and slow growth. Yes, this is a significant blight on the global capitalist system – but it should enable humankind to learn from mistakes and not to retreat into the laager!

Implications of the global financial crisis for commodities

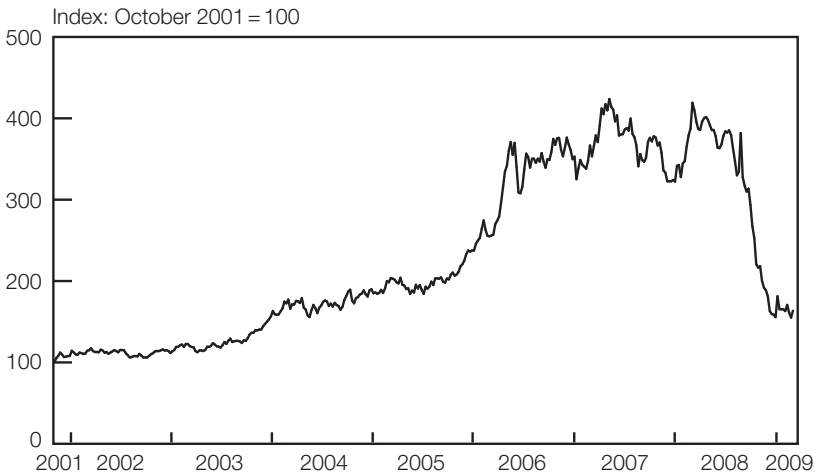
The global economic picture is critically important for the economic health and prospects of the global mineral-resources sector. The recent global commodities boom, which commenced in October 2001, was driven by a confluence of positive factors including

- materials-intensive growth in developing countries and emerging economies with a fast-growing populous (i.e., Brazil, Russia, India and China (BRIC)), driven by significant urbanisation and industrialisation processes;
- reasonable economic growth and the concomitant demand for minerals in advanced economies;
- constraints in supply from mining companies. Mineral supply was relatively constrained as the mining industry grappled with the six 'Ps': constraints in the form of (1) people, (2) procurement, (3) power, (4) permits, (5) projects and (6) politics, resulting in declining stock piles for various minerals; and
- the weakening US dollar.

All these factors had worked together to propel commodity prices upwards. Between October 2001 and mid-2007 the Economist's Metals Index rose by 384 per cent over a period of 84 months, making this boom one with the longest duration and the largest in recent times. However, the sub-prime-induced financial crisis, with its feedback loops back into the real economy, has resulted in two of the above-mentioned variables turning negative. First, economic growth, which is traditionally driven by

consumer expenditure, has collapsed in the advanced economies. Given that these economies account for more than 50 per cent of global GDP and for about 40 per cent of total mineral demand¹ the migration into economic recession has weakened the demand outlook for minerals significantly, while economic growth in these countries remains weak. This, in turn, has resulted in a build-up in stockpiles of various minerals. The second key issue is that the US dollar has strengthened against the euro as investors sought 'safe-haven status' in the US Treasury bill market. The result has been that since July 2008 the Economist's Metals Index has fallen by 50 per cent as most metal prices experienced a significant price reversion.

Figure 2: The Economist's Metals Index, US\$ terms, base indexed from October 2001 to March 2009



Source: Economist.com

Nevertheless, the underlying structural demand story related to the materials-intensive growth in the BRIC economies has not gone away. The body of evidence of the factors supporting this commodity boom has been related to strong demand for minerals, especially in the fast-growing populous countries such as China and due to constrained supply. The fact that the economic growth rates of the BRIC countries are, in part, attributable to their significant urbanisation and industrialisation trends and high investment rates in infrastructure has supported the thesis that the 2001 commodity boom was more *structural* in nature than purely cyclical. In other words, demand for commodities will not totally collapse as the BRICs countries are likely to spend US\$22 trillion on infrastructure in the next decade and some 1,4 billion people are expected to urbanise in the next two decades, while mineral supply was expected to remain relatively constrained as the mining industry grapples with the six 'Ps'.

However, the financial crisis-induced global economic slowdown has already affected the global demand for minerals and some sections of the mining industry have already started to curtail supply in response to weakening demand conditions. Is this the end of the structurally driven commodity bull market? While there is little doubt that the short-term global economic wobble will undermine the commodity cycle, does it mean that the underlying structural factors have disappeared? Yes, the 2001 to 2008 commodity bull market had been driven by a confluence of positive factors listed above, and while some of the positive factors have fallen away (such as the reasonable economic growth in the rest of the world), it does not mean that the materials-intensive growth in the BRIC economies has also collapsed. Yes, the growth rates of these economies will slow down, but they will not go into recession.

Unfortunately, the decoupling theory proposed by several economists, which suggested that the factors driving economic growth in emerging economies were separate from the growth drivers in advanced economies, has proved to be incorrect as all economies have felt the impact of the global financial crisis. This illustrates the increasingly interconnected world in which we live.

However, it is clear that markets exhibit 'irrational exuberance' on the way up and 'irrational pessimism' on the way down. The challenge is that, while it appears that the reversion in commodity prices may have been overdone, it is difficult to predict with any accuracy when some sort of semblance of order will return to the markets and when commodity prices will cover the true long-run marginal production costs of mining more appropriately. It is clear that, in the short term, the order of the day will be volatility in all markets, including the commodity markets.

Likely duration of the financial crisis-induced economic slowdown

The critical question is how long this financial crisis will last? The Japanese banking crisis of the 1990s lasted a whole decade due to a weak and delayed response by government. The Swedish banking crisis lasted 18 months as that country's authorities responded expeditiously to recapitalise their banks. However, this crisis is more serious in terms of magnitude and breadth. While there has already been a speedy response in the developed world to help restore confidence in the system, it is interesting to note that many emerging economies have also responded with lower interest rates and fiscal stimulus programmes. At this stage most economists are expecting a weak global growth performance in 2009, with a recovery in the global economy towards 2010. The amount of liquidity available to emerging-market economies in 2009 is expected to

be half of that made available in 2008, but in the short term, very little credit is available. This does not mean that funding will be unavailable. It means that less will be available and that the costs of accessing the capital will be higher.

Impact of the global economic crisis on South Africa

While ranked in the top 20 economies by size, the South African economy is relatively small and accounts for less than 1 per cent of global GDP. For a small open economy such as South Africa, which is dependent on foreign trade and attracting foreign savings to prop up domestic investment, the country will not be immune to the impact of the global financial crisis-induced economic slowdown. Slower economic growth (and recessions) in key export markets, combined with lower commodity prices and a slowdown in capital flows to developing countries, will impact on the South African economy. Already, certain components of the domestic economy are in recession, including the automotive, mining and retail sectors, although it is important to differentiate between domestic and international factors in relation to the slowdown of sectors.

However, despite being a small and open economy intricately woven into the 'fabric' of the global economy, South Africa's economy has initially weathered the global storm relatively well. Low levels of external debt, appropriate fiscal and monetary policies and a flexible exchange rate have helped 'buffer' the economy against the global storm. Yes, economic growth has slowed, but it is not yet in overall recession. Yes, various sectors remain under pressure, but appropriate counter-cyclical fiscal policy and the large infrastructure investment programme are helping to take up some of the slack. Compare the performance of South Africa to other developing countries, such as some of the Baltic countries, where high levels of external debt and inappropriate fiscal policy have forced these countries to seek IMF bail-outs. So South Africa's economy has done relatively well, but challenges will continue to increase in the short and medium term.

The reality is that, despite having the appropriate buffers, many sectors and many companies have moved into 'survival mode', which means they are focused on surviving the global crisis. However, *the critical point to be made is that if these companies and sectors can be helped to survive, then a significant portion of the labour force will remain employed. The key business input is therefore that a growing vibrant private sector is the basis for creating and retaining employment in the South African economy.*

In addressing these challenges, stakeholders must guard against 'knee-jerk reactions' to structural issues in the global economy. Stakeholders must be careful not to jeopardise long-term prosperity in responding to the

current crisis. In averting the current challenges, social partners must strike a skillful balance and avoid adopting policy responses that will jeopardise the long-term economic sustainability and prosperity of South Africa.

Impact of the global economic crisis on the South African mining sector

The global picture is clearly important for a large mineral-producing country such as South Africa. Despite the global commodities boom and a recovery in fixed investment in the sector, mining production in South Africa has continued to decline and the country has not been able to take full advantage of the global boom. A combination of factors has been responsible, including infrastructure challenges (rail, ports and electricity), regulatory red tape (especially environmental permits) and production disruptions due to safety shutdowns. The additional issues of the squeeze on the global banks and investors will also affect the funding of projects going forward. The following are the likely implications of the financial crisis-induced global economic slowdown for the South African mining sector (with the caveat that the impact may be different per mineral):

- Revenues for some minerals are likely to decline precipitously in 2009 as the sharp fall in US dollar prices has not necessarily been compensated for in terms of depreciation in the rand exchange rate. For example, in the case of platinum group metals, assuming a 10 per cent decline in production in 2009 (on 2007 data), plus the current price of about US\$900 per ounce produced, would result in revenues of ZAR60–ZAR70 billion, versus the ZAR90–ZAR100 billion achieved in 2008. Whereas in the coal sector, while export prices have declined there is the 'base load' of locally sold coal where prices will remain stable. In the diamond market, given that 75 per cent of the market for cut diamonds is the US, Japan and Europe, and these countries or regions are going into recession, the ability to sell diamonds into these markets has diminished and prices have declined by 30–50 per cent. The challenges regarding the delayed release of diamonds once the 10 per cent has been offered to the State Diamond Trader have also prejudiced the diamond mining companies.
- Lower revenues and higher production costs will result in a number of mines at the upper end of the cost curve being forced to cut costs, restructure, delay capex, and may possibly result in the closure of shafts and in some cases force shafts to be placed on care and maintenance. The reality is that some mines or shafts face imminent closure as their costs of production unsustainably exceed their revenues. Again, this will vary according to mineral type.
- The restructuring of these operations to enable survival is likely to have employment consequences. Again, this will vary according to mineral type.

- It is clear that most mining companies have been forced to review capital investment and exploration programmes. This will result in a reduction in capital investment in the sector and may lead to certain expansion projects being placed on hold. However, a number of the capital investment projects that are core to some of the companies will be sustained through this challenging period.
- The decline in the availability of credit or liquidity will affect all mining companies, but the junior resource companies will be harder hit. This is likely to force further consolidation in the mining sector and reduce the growth rate in the junior sector.
- The levels of corporate taxes paid by the mining sector will plunge. In 2007 the sector paid R22 billion in direct corporate taxes, which represented about 20 per cent of all corporate taxes paid.
- Shareholders will receive substantially lower (if any) dividends in the next 18 months as mining companies focus on survival and cost containment.
- The impact on the South African economy will be substantial. Export earnings, GDP growth, investment and employment are all likely to be affected by this crisis. Smaller capital spending and a focus on cutting costs in terms of procurement will affect all supplier industries.

In essence, most of the mining companies have gone into *survival mode*, with significant consequences for the South African economy.

Possible elements of a short-term support package for the South African economy

Ultimately, the South African response “needs to be *timely, targeted, and temporary* for it to be effective”. It is thus crucial to focus on alleviating short-term societal pressures, namely unemployment and poverty, while supporting private-sector stability, and simultaneously charting a path for sustained future economic growth. In this regard, it is important that appropriate messages are communicated by the leadership of all stakeholders. It is important that such messages reinforce South Africa’s commitment to achieving stated socio-economic objectives; and prudent macroeconomic management.

Perhaps the most important component of any short-term package of measures to help South Africa ameliorate the impact of the global crisis has to be *ensuring that the confidence of investors, the business sector and consumers is not further undermined by any proposals*. Rather, a central theme of any short-term package should be the *maintenance and improvement in confidence in dealing with the economy*. This requires a focus on continuing with the predictability and stability of economic

policies. It must be remembered that as a small open economy South Africa is reliant on growing foreign trade and attracting foreign capital to supplement its investment.

We are all aware that to support higher economic and employment growth in South Africa, we need high rates of fixed investment. It is estimated that over the longer term, for any economy to grow sustainably at a rate of over 5 per cent per annum, an investment rate of 25 per cent of GDP is required. South Africa's investment rate is currently about 22 per cent of GDP. Owing to the country's low savings rate of only 14 per cent of GDP, South Africa has to borrow the balance from rich countries, which results in an 8 per cent current-account deficit (also known as our savings-investment gap). The key point is that to attract the foreign capital, and to promote business and consumer confidence, there has to be stability and predictability in economic policy-making. The recent decline in the South African Business Confidence Index to the lowest level in a decade highlights the risk of any sudden policy changes.

South Africa does not have the same extent of the challenge facing many advanced economies. There does not have to be a bail-out of the banking or other sectors. What is needed is a focus on ensuring that sectors facing problems survive and that South Africa positions itself for future growth.

Specific mining-sector proposals

The mining-industry stakeholders established the Mining Industry Growth, Development and Employment Task Team (MIGDETT) on 1 December 2008. This task team has two mandates: the first is to make recommendations on how to get the mining industry out of the immediate crisis, while the second is to identify all the issues needed to be addressed in order to position the industry to benefit from the next economic upturn. MIGDETT met on four occasions and two main stakeholder principal meetings have taken place to consider the task team's findings.

Recognising significant pressures for survival that a number of companies are facing in the short term and the stakeholders wanting to try and save jobs in the sector, the stakeholders recognised the need to be as flexible as possible to deal with the issues (and to employ some 'out-of-the box' thinking on solutions). The following bullet points summarise an array of issues that were proposed by stakeholders.

- *Reducing cost pressures on mining:* In order to reduce costs and cost pressures to try and keep mines viable and to help preserve employment, the stakeholders should consider ways and means of reducing cost pressures in the industry.
- *Significant financing pressures faced by mining companies:* In the short term, liquidity from international sources is not readily available

for all mining companies, but especially the smaller ones. This significantly impacts on exploration (especially Greenfields exploration), project development and trade financing. What are the roles of direct foreign investments (DFIs) and credit markets in managing the crisis and enabling companies to weather the storm?

- *Mitigating issues that affect production and revenues of the mining sector negatively:* The MIGDETT proposed that stakeholders consider addressing issues (e.g. electricity supply and red tape) that affect mining production, which, in turn, helps reduce costs and stabilises mines.
- *Compliance with legislation in respect of retrenchment:* The task team developed draft guidelines on compliance with the statutory requirements for fair retrenchments. This includes the provisions of the Labour Relations Act and Mineral and Petroleum Resources Development Act (MPRDA), and the timing of the application of section 52 of the MPRDA. In the event that retrenchments are inevitable, these guidelines are to be followed by mining companies as a last resort.
- *Alternatives to retrenchments:* The parties were urged to look at possible alternatives to retrenchment, including areas such as internal company transfers and redeployment and extended leave periods.
- *Mitigating the result of retrenchment:* The Department of Labour and Department of Minerals and Energy have key roles to play in ensuring that social plans are activated when retrenchments take place. Where retrenchments become inevitable, measures such as evoking training to empower workers in different skills should be explored by the stakeholders.

Medium- to long-term issues

As agreed, the stakeholders will investigate unblocking the issues that affect the ability of the sector to respond to the next up-cycle positively. Issues such as dealing with infrastructure bottlenecks, red tape and human capital, in the medium- to long-term issues will require intensive discussion.

Note

¹ PWC 'mine' statistics of mineral sales for the top 40 mining companies by customer location.

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