South African Reserve Bank

The impact of the Eurozone and global financial crisis on South Africa

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Ladies and Gentlemen

All protocols observed

The waves of the global financial crisis hit our shores as expected. The ferocity with which they hit our country was more pronounced than we could ever imagine. Fortunately, South Africa had built strong policy anchors. Nevertheless, the impact reverberated across the entire economy. Tonight I would like to take you through our experience through the waves. I want to say a few things about the South African economy in the global financial crisis and its current European incarnation. In particular, I want to provide some perspective on the economy's resilience to global shocks and how our macroeconomic policy settings enable the economy to weather global storms.

A crisis in waves

The global economic crisis came in waves. The initial surges were relatively supportive of the economy. Rising commodity prices in the period from 2003 to 2008 increased the terms of trade of the economy in a strong and sustained way, boosting export revenue and making rising import prices tolerable. Over this period, 2003 to 2008, the terms of trade increased by 7.1 percent.

A steady flow of saving from non-residents into rand-denominated assets contributed to cheap financing and with a stronger currency made possible the importation of considerable capital equipment, a less costly infrastructure build programme, and improved welfare for households as imported consumer goods became less costly. From 2003 to 2008, real household consumption growth averaged 5.8 percent. Real gross fixed capital formation grew by an annual average of 12.6 percent. Compared with the 1990s, average annual real GDP growth was 4.6 percent over this period. The manufacturing sector alone had real fixed capital formation growth averaging 3.7 percent a year and grew by an annual average of about 4.0 per cent.

The second wave was much less benign. This was the sustained rise in global food prices, which generated strong upward pressure on domestic food prices and eventually the overall price level. Headline inflation rose strongly, peaking at 11.1 per cent in September 2008. The rise in inflation and subsequent monetary policy response (the policy rate increased from 7.0 per cent to 12.0 per cent between May 2006 and June 2008) sharply worsened the financial conditions of South African households and corporates that had increased their levels of indebtedness in the period prior to 2007. The various positive factors of the 2003 to 2007 period had resulted in a sharp rise in indebtedness which could not be sustained as growth and income in the economy slowed and inflation increased. Indebtedness of South African households had increased from 54.5 percent of disposable income in 2003 to 82.3 per cent by 2008.

The slowly unfolding financial crisis in the United States and the eventual shock of the Lehman bankruptcy in October 2008 hit an already weakening economy. As credit was restricted globally and trade volumes collapsed around the world, the value of real exports of goods and services from South Africa fell by 19.5 percent in 2009. For many economies, including South Africa, the decline in trade triggered the actual recession as it led to sharp contractions in output and labour retrenchment. South Africa's quarter on quarter annualised growth in gross domestic product contracted by 1.7 per cent in the fourth quarter of 2008, falling to -6.3 and -2.8 per cent in the first and second quarters of 2009 respectively. The economy's real GDP growth rate was -1.5 per cent in 2009 and 2.9 per cent in 2010.

Stronger commodity prices in the boom period had pernicious effects as the crisis unfolded. Exogenous shocks from food and oil prices combined with domestic inter-sectoral dynamics pushed nominal wage settlements to very high growth rates given the slowing economy. Unit labour costs increased sharply as a result.

The labour market outcomes in South Africa were severe. While about 1.6 million net jobs were created in the period 2003 to 2007, from 2008 to 2010 roughly 800 000 net jobs were lost. Job losses were heaviest in construction, retail, and financial services, which were the major job gainers in the boom period. A key distinction between South Africa and most other countries' experiences in the crisis has been the extent of job destruction, particularly considering the relatively shallow recession we experienced.

Stronger economic performance in 2010 gave way to much more volatile real economy outcomes in 2011. Some of this had to do with adverse international economic events, including the tsunami in Japan and sharply elevated oil prices due to the conflict in Libya and political uncertainty as the Arab Spring unfolded. But a large portion of the domestic output volatility was related to domestic factors, including the debate on nationalisation of mines, work stoppages in manufacturing industries, health and safety shutdowns, and a lower output in an agricultural sector that had grown very rapidly in previous years. The marginally stronger growth rate in 2011 (estimated at just over 3 percent) compared to 2010 (2.9 per cent) was due to better outcomes in tertiary sectors, particularly trade, catering and accommodation, transport, storage and communications, and financial services, underpinned by sustained growth in government spending.

How did we respond to the crisis?

Given the unfolding of the shocks hitting the South African economy, the monetary and fiscal policy responses were largely reactive. The main forward-looking macroeconomic policy setting and decisions were made some years earlier, and enabled a sustained moderation in the economic effects of the crisis. Like many other emerging market economies, capital inflows and upward pressure on the exchange rate played a complicating role in how the economy responded to the shocks and to policy.

The inflation targeting framework, put in place in 2000, had largely aligned inflation expectations of economic agents with the Reserve Bank's forecasts. With a change in policy on exchange market intervention, the IT framework also allowed the currency to float and absorb major shocks without forcing major interest rate adjustments. This cushioning role was critical at the time of the Lehman crisis, because it allowed the monetary authorities to continue lowering interest rates as inflation moderated even as investors sold rand denominated assets in the near-panic selling of 'risky' assets of the time. Post-Lehman the value of the rand against the US dollar declined by about 35 per cent as did the currencies of many emerging market economies.

South Africa’s sound fiscal position and the high level of commodity prices implied a return of capital into the economy once risk perceptions had moderated. Over the course of 2009, the rand strengthened, averaging R8.44 to the US dollar in the year, and beginning 2010 at R7.37. The underlying real equilibrium exchange rate of the rand was high because of the terms of trade and sound policy.

The initial sharp depreciation of the currency might have generated stronger economic outcomes for exporting and import-competing sectors, but it is likely that the net effect of a persistent depreciation on the economy would have been negative at the time. It is also important to remember that these competitiveness gains would have been very small due to the sharp moderation in consumer spending and the fall in foreign demand for all South African exports. In other words, South African exporters outside of the commodity sector might have benefited marginally from higher domestic prices, but only for a short period as their input costs escalated. As those costs rose, the likely interest rate response to the inflationary effects of the exchange rate drop would have squeezed domestic demand even as rising inflation appreciated the real exchange rate and reduced the initial improvement in competitiveness.

South Africa’s policy discourse at the time, centered on the need for a fiscal stimulus response to the fall in foreign demand and slowing domestic economy. This was incompatible however with a macroeconomic response to those advocating a moderation in the appreciation of the currency as it rebounded from the overshot depreciation in late 2008. In addition to the positive economic factors driving the resumption of capital inflows – the sound public debt position and high commodity prices – the high inflation rate and growth in unit labour costs were driving up the real effective exchange rate. The current account deficit remained high as a result of growth in gross domestic spending exceeding growth in domestic production.

These factors meant that monetary policy alone – lowering the policy rate to reduce carry trade – could not have prevented the appreciation of the nominal and real exchange rates. To prevent the real appreciation would have required macroeconomic policy tightening to rein in domestic expenditure and moderate inflation. In practice this meant either that the foreign currency public debt would have to increase by the amount the authorities were willing to intervene in the foreign exchange markets, or fiscal policy would have to adjust to find the resources for foreign currency purchases out of current spending or from increased revenue. Short of increased borrowing and the implications for long-term interest rates, the other options entailed reducing public spending on current programmes or tax increases.

The approach taken was to provide funding to purchase foreign currency inflows from foreign direct investment. Where there has been insufficient rand available for this purpose, forward market foreign currency swaps were conducted to finance the reserve purchases.

Even the efficacy of macroeconomic policy adjustment to achieve the real depreciation is in doubt. Despite the sharp punctuations of risk aversion resulting in sales of emerging market assets, global macroeconomic rebalancing has been marked by a sustained flow of capital out of some advanced economies and into faster growing and higher return emerging and developing economies. For economies like South Africa that for one reason or another are seen as good investment destinations, this flow is unlikely to dry up soon. The corollary is to take a bet that China's growth rate will slow permanently, resulting in much lower commodity prices, and hence a fall in South Africa's terms of trade. This seems an unlikely bet to take. In that global context so heavily influenced by China as the world's primary driver of economic growth, adjustment to the nominal exchange rate might be expected to generate further portfolio capital inflows.

Another alternative was for the imposition of capital controls or taxes on capital inflows to reduce the return on rand-denominated assets. Such controls were put in place in some countries, primarily Brazil. These may have adjusted the composition of inflows somewhat towards more foreign direct investment, although the evidence provides little grounds for a robust assessment one way or the other. Like the option of a fiscal contraction, the imposition of taxes on capital inflows would force a reduction in domestic spending and would need to be large enough to tighten policy to offset the inflationary impact of eased policy rates.

Perhaps the remaining option at the macroeconomic level would have been to fix the exchange rate against another currency. With lower inflation rates in major currencies, this would have likely resulted in the need to tighten monetary policy immediately. From a policy perspective, fixing the nominal rate would also have severely limited South Africa's options and forced domestic monetary and fiscal settings to adjust domestic demand to maintain whatever currency peg was chosen. Imposing domestic economic volatility to solve exchange rate volatility would be a strange choice to make.

On balance, it is unclear that any of the macroeconomic options *not taken* would have resulted in better economic growth, investment or employment performance than actually occurred. It is possible that somewhat tighter fiscal policy and somewhat looser monetary policy could have resulted in a slight change in the balance of production between traded and non-traded goods, but the economy-wide economic growth rate would likely have been lower and fewer jobs created. The non-traded goods sectors have tended to grow faster than traded goods and are more labour intensive, irrespective of the strength of global demand. The floating exchange rate has enabled South Africa to weather the global crisis without having to impose jarring interest rate hikes, meaning that households and firms could pay down debt more rapidly and the recovery initiate sooner. Perhaps more importantly, a series of clear constraints to growth in traded goods sectors have been identified for some years and new ones have emerged to frustrate sustained growth in output.

The capital flows challenge needs fresh thinking. Over the medium term, to moderate the real exchange rate, we need fiscal and monetary policy settings that reflect that policy objective and seek to achieve it. For fiscal policy this means a credible consolidation path and a return to sustainable public debt levels. It also implies that public spending be directed at addressing South Africa's competitiveness challenges and infrastructure needs. Getting these areas of policy right, in turn, implies that foreign investment will start to shift in composition towards greater FDI relative to portfolio investment and in a wider range of industries. More efficient infrastructure, more competitive firms with sustained productivity growth, and more skilled labour are as integral to achieving a permanently more competitive economy as forward-looking fiscal and monetary policy settings.

How we address our home-grown economic challenges is not to suggest that global difficulties can be left unattended. Three serious disorders confront the short and medium term. The first is the effects of macroeconomic policy making in advanced economies. These policy settings, intended to resolve the combination of slow growth and over indebtedness, and conducted in a globalised world economy; contribute at some level to the flow of capital into emerging markets and the developing world.

Like the experiences of the Asian crisis over a decade ago, for some economies these flows run the risk of pushing economies into very poor decisions of what to do with the surplus of capital. Capital pushed into uses where the returns are speculative and high will tend to result in inefficient use of capital and cause foreign currency liabilities that cannot be met. For other economies, such as South Africa, the flow of capital may ease the adjustment process by enabling a faster consolidation away from unsustainable fiscal positions.

But they also can result in Dutch Disease effects, particularly as in South Africa, where shocks affecting one sector are transmitted to others via input pricing and sector-level collective bargaining. The trade channel works in the opposite direction. The markedly slower economic growth of advanced economies will result in lower exports in the short term and will accelerate the shift in exports towards more rapidly growing regions. China is the fastest growing export destination for South Africa, while India and a number of African countries are also receiving a rising volume of exports. The slowing advanced economies however also pose a less obvious trade challenge to South Africa's manufacturing ambitions. The market space for South Africa's relatively high cost and specialised manufactures will narrow and competition will increase with Asian competitors.

For the time being, job creation is more likely to rebound in sectors that did well prior to the crisis, and indeed this is what we have seen over the course of 2011. Public sector job creation has been strong in 2010 and 2011, which has given way to stronger private sector job creation in the second half of 2011. Stronger public and private investment should be expected to result in better employment creation over the medium term.

The second disorder is in financial markets in advanced economies. High debt levels in the developed world and the European sovereign debt crisis have triggered unconventional policy responses and a variety of risks is evident. The most troubling is the possibility of the current financial crisis intensifying sharply and resulting in even more credit contraction, sales of assets, and eventually stronger real economy effects. A severe worsening in the growth prospects for Europe would result in a calamitous fall in demand for exports from around the world. A global recession could ensue from this kind of risk. South Africa's trade exposure to Europe is about 27 percent of total exports. A second and more plausible scenario is for a sustained period of very weak credit extension in Europe due to the combination of the Basel III capital requirements and exposure to sovereign debt in peripheral European economies. This outcome might play itself out as a serious drag on European growth, with GDP growing at roughly half the average rate achieved over the last twenty years.

A third possibility would be for financial contagion to affect emerging market economies. In this instance, countries with financial and/or economic vulnerabilities would experience local currency asset sales, capital flight, and knock-on effects into confidence of consumers and businesses in the real economy. Such effects would very likely occur in the event of a financial and economic meltdown in Europe, but would not necessarily only come out of such a combination of circumstances.

The private sector in emerging economies remains in deficit to the rest of the world and only Asian emerging economies have net foreign asset positions. As European banks recapitalise, the resulting deleveraging could reduce foreign funding for emerging markets significantly. European banks provide about 30 per cent of Latin American bank credit and 40 per cent of Eastern Europe's so that a contraction in EU bank loans to these countries could constrain their economic growth significantly. The prolonged global crisis and the vulnerabilities created or exposed by policy efforts in South Africa and elsewhere to address the crisis have to some extent increased the risk of financial contagion. In that context, reducing vulnerabilities must be a key priority for the monetary and fiscal authorities.

To conclude, SA fared better than many peers. Going forward, reducing vulnerabilities would entail strengthening our three key anchors.

South Africa has almost no direct financial exposure to institutions in Europe, in part because of limited direct institutional linkages and in part due to our pre-existing macro-prudential policy framework, a key anchor. Nonetheless, reorganisation of the regulatory approach to the financial sector is underway to strengthen the capacity of regulators to address sector-specific challenges that may arise in the future and enable appropriate responses in the event of shocks. Basel 2 provides the basic template for our domestic regulatory initiatives, even as discussions on Basel 3 plus appropriate flexibility for emerging market economies are ongoing.

On the fiscal policy side, the medium term expenditure framework sets out a consolidation path that caps the rise in the public debt at comparatively low levels. As the economic recovery proceeds, the fiscal position will show further sustained improvements as we have seen in the latest budget numbers.

Lastly monetary policy: the financial shocks that South Africa will face in future will continue to be best addressed with a flexible inflation targeting framework that allows the currency to cushion the domestic economy from volatility. Forward looking inflation expectations and transparency by the monetary authorities hold the key to minimizing exchange rate pass-through to domestic inflation. This will not always work as well as we would like, but is far better than the alternative of having to move domestic interest rates on a frequent basis to try to maintain a stable exchange rate. Underlying the sustainability of these macroeconomic policies must be efforts to improve productivity, skills development, and improve the flexibility of wages and prices. Stronger economic growth, sustaining people in jobs and more rapid job creation are our best defences against the economic shocks of the world in which we live.

Thank you.