South African Reserve Bank

Headwinds from the global crisis: the need for proactive responses

Address by Gill Marcus, Governor of the South African Reserve Bank, at the ORT SA Fundraising Dinner, Sandton, 31st July 2012

This evening is a celebration of the work that ORT does in promoting education and training in South Africa. The focus could not be more appropriate: education and training is key to giving each and every South African a real chance in life, the ability to break cycles of poverty, and is an imperative for long term economic growth in this country, which faces huge legacy challenges in the education system. Sadly, despite significant resources being allocated to education, many parts of the system remain dysfunctional. A literate and skilled labour force is necessary to ensure domestic growth, employment opportunities, social stability and cohesion, and the ability to compete globally.

Unfortunately the global environment in which we find ourselves is extremely difficult and is likely to remain so for a good number of years. The challenges facing Europe are of a long term nature, so even if appropriate steps are taken at this stage to deal with some of the issues that are making the headlines, the best case scenario will still be one of slow growth for some time to come before the required structural reforms can take place and take effect.

This is supposed to be a light-hearted evening where we can relax, share jokes and enjoy ourselves. Unfortunately, we cannot ignore what is happening in the world around us, recognising that behind the numbers, often in the hundreds of billions, that are frequently referred to stand tens of millions of people whose lives, hopes and dreams have been altered forever.

Central bankers have the reputation of being the party poopers, the ones who take away the punch bowl as the party really gets started, as our function is often to guard against excesses of various kinds. Tonight my role will be no different. We are living through extremely challenging times, and unless we recognise the gravity of the situation, we will not take the required steps in time to create a buffer against the risks that we face. At the root of the problem is the global economy, but underlying problems and the structure of our own economy and society will shape how the global downturn will impact on us.

The recent data coming out of the world economy makes depressing reading. In the last two weeks or so alone we learned the following: the UK economy contracted by 0,7 per cent in the second quarter (an annualised rate of -2,8 per cent), far more than expected, and remains in recession; the US economy grew at an annualised rate of 1,5 per cent in the second quarter, about half its potential growth rate, and is in danger of falling over its self-induced fiscal cliff; German business confidence declined for the third successive month, far more than expected, to its lowest level in two years; Eurozone business declined to a three year low in July, while almost half of the members countries are experiencing negative growth; unemployment in the Eurozone reached new euro-era highs at 11,1 per cent in May, with youth unemployment in excess of 22 per cent; spreads on Spanish and Italian sovereign debt have reached new and unsustainable highs; the global PMI is now indicating a global contraction; and systemically important emerging markets, until recently the main ray of hope in a dismal world, are also slowing markedly, particularly China, India and Brazil. The litany is almost endless.

If you were hoping for some countervailing good news, it has been hard to find. Perhaps we can point to remarks by the ECB Chairman, Mario Draghi, that the ECB would “do what it takes” to safeguard the euro generated a relief rally in global financial markets late last week. But we would be fooling ourselves if we think that the problems are over. Verbal intervention by central banks can have an impact, but the sustainability of these effects will be dependent on evidence that their words can be backed up with deeds. Until the substance of such assurances materialise, we are likely to see continued volatility as markets react to good news, more in hope than anything else, only to be disappointed and to revise their assessment soon after. The ECB is a central part of the solution, but it cannot act unilaterally to extend its mandate, and getting agreement on these issues at a political level is far more complex.

Perhaps some other relatively good news is that the downward revisions in July by the International Monetary Fund (IMF) to its global growth forecasts were relatively modest- by 0,1 and 0,2 for this year and next year respectively. But we can take cold comfort from the size of the revision. Of concern is that the downside risks are seen to “loom large”, as the forecasts are predicated on a number of conditions, one of which seems unlikely to be met very soon: namely that “there is sufficient policy action to allow financial conditions in the euro area to ease ...” According to the IMF, the situation in the Eurozone will “likely remain precarious until all policy action needed for a resolution of the crisis has been taken”.

There seems to be no near-term or easy solution in sight, as the problems are multifaceted, and there is no agreement within the euro area as to how to go forward. Indeed there is no agreement among economists either. And as the situation worsens, negative feedback loops intensify. The underlying problems involve three distinct but interrelated problems: a sovereign debt crisis, a systemic banking crisis and a growth crisis, which have combined in a way that has significantly increased unemployment. But while everyone will agree that there is a growth crisis, analysts differ as to the causes and therefore the cures for this.

Much of the focus is on the fiscal side, with many seeing the solution being one of fiscal austerity all round. However, as Paul Krugman and Richard Layard have recently argued in their “manifesto for common sense”, the crisis did not originate in the public sector, but rather, expanding public sector deficits were a consequence of the bursting of the unsustainable private sector expenditure bubbles which then contributed to reductions in output and tax revenues. They argue that the crisis, which originated in the advanced economies, was fundamentally one of excessive private sector expenditure, driven by excessive borrowing and lending and over-leveraging by banks. When the bubble burst, the public sector had to fill the expenditure gap. With the private sector still deleveraging, fiscal austerity will only intensify the downward growth spiral.

This can be clearly seen from the data of public sector deficits before and after the crisis. In 2007, the overall gross debt/GDP ratio of the euro area was 66,4 per cent. In 2011 it had risen to 87,4 per cent. If we look at some of the countries that have come under the spotlight recently, we see pre-crisis debt ratios at relatively modest levels in some cases, but accelerating significantly thereafter. For example in 2007 the Spanish debt ratio was 36,3 per cent but in 2011 had grown to 68,5 per cent; the debt ratio of Portugal increased from 68,3 per cent to 107,8 per cent; that of Ireland from 24,8 per cent to 108,2 per cent; that of Greece from 107,4 per cent to 165,3 per cent and the Italian ratio increased from 103,1 per cent to 120,1 per cent.

These data illustrate three important points: first, that sovereign debt crises in some countries did not originate in the public sector; that debt ratios can accelerate very quickly from seemingly benign and sustainable levels; and that any given level of debt may be seen to be sustainable, but if the bond markets change their view on this, spreads rise to the extent that the costs of servicing these deficits can rapidly turn sustainable deficits into unsustainable ones.

These debt ratios have increased because of widening current fiscal deficits in response to the crisis, and not necessarily because of previous excessively large deficits. For example, in 2007 Ireland and Spain had fiscal surpluses and the deficit/GDP ratio in Portugal and Italy were 3,1 per cent and 1,6 per cent respectively. Greece on the other hand already had a deficit of 6,5 per cent.

At a time of continued private sector and bank deleveraging, excessively deep public sector austerity is likely to generate and reinforce negative growth and debt dynamics: as growth falls, the debt to GDP ratio increases, and if debt is reduced too fast, growth will fall even more.

There is no doubt that some countries have excessive fiscal burdens and unsustainable fiscal positions. Those countries have to adjust, and take the pain, but a key question is over what time horizon. Nor does it mean that all countries should be following austerity measures. If they do, and the austerity measures proposed are excessive, it will only reinforce the global downturn. The pace of fiscal consolidation has to be more measured, and it is for governments and the central banks to ensure that their interventions keep the markets in check. As Krugman and Layard have argued, “at a time when the private sector is engaged in a collective effort to spend less, public policy should act as a stabilising force, attempting to sustain spending. At the very least, we should not be making things worse with big cuts in government spending or big increases in tax rates on ordinary people”.

This does not mean that governments should go on a spending spree. More focus should be placed on the efficiency of government expenditure, to ensure that it is of the type that is likely to generate growth, and not simply be an irreversible increase of social expenditure. Furthermore, expenditure that is likely to crowd in private sector investment would be even more appropriate. But the focus does not need to be only on expenditure. Tax reductions or tax incentives, appropriately focused on growth-generating activities, for example on small businesses, would have a similar effect.

The sovereign debt crisis is intertwined with the banking crisis. Banks are major holders of sovereign debt, and they have seen the value of their holdings declining. At the same time, many banks had excessive exposures and leverage to the property market, particularly in Spain, and the property market bubble has since burst. In addition, the stricter global banking regulations, commonly referred to as Basel III, have imposed higher capital adequacy ratios on banks, and they are trying to achieve these by selling assets and reducing lending. The Spanish banking system in particular is under stress and requires a bail-out, which in turn will put further pressure on the Spanish fiscal position, as was the case in Ireland. One of the currently intractable issues in the Eurozone is whether the ECB can bail out these banks directly.

Fiscal austerity and bank deleveraging, while contributing to the negative growth outlook in Europe, are not the only growth constraints. There is no doubt there is also a structural element to the Eurozone crisis, in part a result of very different structural features in the member states. After unification, the German economy underwent an extended period of restructuring. The economy became more efficient, more productive and competitive, particularly relative to many of its Eurozone partners. In the face of labour and product market inflexibility and higher wage growth in many of these countries, current account deficits were widening and were readily financed at low Eurozone rates of interest, given the prevailing assumption that all euro area sovereign bonds were the same. As we have seen, this assumption no longer holds, but the divergences in competitiveness remain.

It has been estimated that most of the peripheral European economies have lost competitiveness relative to Germany in the order of magnitude of between 20 to 30 per cent since the introduction of the euro. This is a longer term structural issue that is likely to take a while to reverse. But it is debatable whether the required increases in productivity, with associated significant wage and price declines and increased unemployment can occur without causing major social upheaval and this at a time when government safety nets are being cut back on. The adjustment will be that much more severe given the lack of an exchange rate policy lever.

An early resolution to the crisis is unlikely because there is a lack of trust at a number of levels. There is a lack of trust in the leadership of the Eurozone to take difficult decisions; there is a lack of trust between countries; there is a lack of trust of the banking system, and the recent revelations concerning Libor fixing and money laundering reinforce that lack of trust; and there is a lack of trust between banks, as evidenced in the dysfunctional nature of the interbank system in Europe. And as austerity measures bite ever deeper, there are limits to how much the electorate can take. Ultimately, the situation becomes increasingly economically and politically untenable.

As the Eurozone crisis impacts increasingly on the rest of the world, it again raises the question that was asked at the beginning of the crisis: can the emerging market economies decouple from the advanced economies? While there seems to be little doubt that the centre of gravity of the global economy is shifting eastwards, and the Asian economies as a bloc may be better able to withstand a renewed global downturn given increased intraregional trade, a complete decoupling is unlikely. Already a number of institutions have downgraded their emerging market growth forecasts and we have seen slowdowns in Asia and Latin America, including China, India and Brazil. In 2010 Brazil recorded an annual growth rate of 7,5 per cent. In 2011 this had moderated to 2,7 per cent, and in the first two quarters of this year, annualised growth rates of 0,8 per cent were recorded. While Chinese growth of 7,6 per cent may seem extremely fast to us, we must bear in mind that it is significantly slower than the levels previously achieved, and further moderation is expected. A recent IMF Survey viewed the slowdown in China as having been initially self-induced, to correct overheating asset markets, but more recently is due to the effects of the global slowdown.

The channels of contagion to emerging markets from the slowdown in the advanced economies are likely to be similar to those experienced in 2008. We have already seen declining emerging market exports and weaker commodity prices, although what happens in China will be an important determinant of the outlook for commodity prices. In general it will be difficult to sustain growth in many emerging markets, particularly those that are non-food commodity exporters, as well as those that have strong manufactured export markets in the advanced economies. There is also some evidence that tightness in bank lending in Europe may be impacting on the cost and availability of trade financing as well, putting further pressure on trade.

Emerging markets are also being affected by the volatile risk perceptions in global financial markets and associated capital flows. In 2009/10, emerging markets were faced with strong capital inflows from advanced economies in search of yield. However, since the intensification of the Eurozone crisis in August 2011, the so-called risk-off scenarios have become dominant. During bouts of risk aversion, the overriding concern becomes security rather than yield, and investors are prepared to pay for such security as seen in the recent negative bond yields in Germany and the negative interest rates on bank accounts in Switzerland. As capital has moved to safe havens, a number of emerging market currencies, including those of Mexico and Brazil, have depreciated significantly. This will not provide a strong stimulus to export growth if the demand is not forthcoming, but may have inflationary consequences, which may limit monetary policy flexibility. For this reason some emerging market economies have intervened to prevent excessive depreciations.

Increased intraregional trade has been an important contributor to the resilience of the Asian economies. The recent emergence of sub-Saharan Africa as a significant growth region, with growth rates in excess of 5 per cent in the past 3 years, has been instrumental in helping cushion South African exports from the global crisis. In 2007, 36 per cent of South Africa’s manufactured exports went to Europe, while 24 per cent went to Africa. In 2011, 29 per cent went to Europe and 34 per cent to Africa. Apart from direct trade, there has also been increased penetration of Africa by South African companies, particularly in the retail, construction and banking sectors, facilitated in part by more generous exchange control allowances for investment into the continent.

Some of the reasons for the recent resilience of regional growth, highlighted by the IMF, include the fact that financial systems in Africa are relatively insulated from global financial developments with banks obtaining funds from domestic deposit bases rather than external sources; increased infrastructural expenditure; improved macroeconomic policy frameworks during the 2000s; fiscal policies generally being supportive of growth since 2009, with average fiscal deficits increasing by three percentage points in that year, with some consolidation (about 0,5 percentage points) since then; variations in monetary policy stances, depending on inflationary pressures; and until recently, relatively strong commodity prices.

However, although there is good news coming out of Africa, the continent will also be impacted by a global downturn, although as was the case in 2008/09, it may be relatively more insulated than other regions. But we cannot be complacent about it. Although growth in sub-Saharan Africa is faster than the global average, it is still lower than the pre-crisis level of around 6,5 per cent. According to the latest IMF Regional Economic Outlook (April 2012), growth in the region is expected to average 5,4 per cent in 2012 and 5,3 per cent in 2013. However, it is mainly the oil-exporting countries that are expected to have higher growth this year (7,1 per cent up from 6,0 per cent in 2011), as non-oil exporting middle income country growth is expected to decline from 4,3 per cent to 3,4 per cent in 2012, and low income countries more or less unchanged. Overall, the risks are seen to be on the downside due to global developments and their possible impact on commodity prices.

Natural resources and commodity exports remain the main growth driver for sub-Saharan Africa, and the region is therefore vulnerable to the global downturn through this channel. The recent increase in global food prices should, however, benefit African food exporters. Just under half of the 45 countries in sub-Saharan Africa are viewed as significant exporters of natural resources, and most of the remainder are dependent on agricultural commodity exports. About half of the region’s exports are non-renewable natural resources, but seven countries are oil exporters and account for more than half the natural resource exports. Thirteen others have at least a quarter of their export proceeds coming from mining. Resource exports as a percent of non-resource GDP is 110 per cent in Angola; 68 per cent in DR Congo; 116 per cent in Gabon; 54 per cent in Nigeria; 38 per cent in Botswana; 52 per cent in Zambia and 8,6 per cent in South Africa.

The impact of the global downturn on South Africa is already evident. Growth has been below potential and moderating, with a progressive downward revision of growth forecasts. In the middle of 2011, the Bank was forecasting a growth rate of 3,9 per cent for 2012 and

4,4 per cent for 2013. The most recent forecasts now show forecasts of 2,7 per cent and 3,8 per cent for these two years, and the MPC viewed the risks to these forecasts to be on the downside. The value of merchandise exports contracted by 2,4 per cent in the first quarter of 2012and the terms of trade have deteriorated for two consecutive quarters. The resulting current account deficit contributed to a weakening of the exchange rate. Capital flows have been highly volatile in response to changing global investor risk perceptions which in turn have impacted on the exchange rate. Since August 2011, the exchange rate has depreciated by around 23 per cent against the US dollar, and the volatility has increased. Employment growth has been positive but sluggish, and we have yet to get back to pre-crisis employment levels.

Growth has been driven primarily by consumption expenditure, but even this is expected to moderate, as seen in the sharp decline in the FNB/BER consumer confidence index in the second quarter. Investment expenditure has also lagged. There appeared to be a steady recovery during 2011, but private sector gross fixed capital formation grew by only 1,8 per cent in 2012. Fortunately some growth is being seen at the public sector level, but the private sector accounts for around 65 per cent of total fixed capital formation.

In such an environment, South Africa’s policy options are constrained. However we cannot just sit back and hope that the world will somehow turn around. And when it does turn around, we should be well-positioned to take advantage of the improved situation.

Macroeconomic policies can help to alleviate the cyclical elements of any possible downturn but both monetary and fiscal policies have less room for manoeuver than was the case in 2008. The recent monetary policy easing should be seen in the context of alleviating some of the strains in the economy, but we emphasised that monetary policy cannot solve the underlying problems of the economy, which will still exist even if the global economy recovers sooner than expected. We need to recognise the structural nature of the challenges facing the economy, and in addressing them we can reduce our vulnerability to global headwinds.

These include addressing the structural nature of unemployment, and require concerted policy coordination across government departments, and between government, the private sector and civil society. It is not my role to provide a comprehensive plan for structural change in the economy but allow me to mention briefly what I think are a few of the top priorities.

The continued focus on infrastructure is essential. This is investment in the future as opposed to current consumption. It is productive, it provides jobs, and it helps alleviate constraints to growth and to exports. Lack of infrastructure has been an impediment to the mining sector's ability to get the ore to the ports, and capacity constraints at the ports are also well documented.

Electricity supply remains a binding constraint on growth. While more capacity is being built, we need to ensure that further delays do not occur, and that planning for future capacity is not left till too late.

Incentives need to be given to encourage the growth of small and medium enterprises, while competition policy should be enhanced to reduce the occurrence of monopolistic pricing and other anti-competitive pricing policies.

We need to encourage regional trade and integration. The advantages of such diversification and expansion are obvious. But we must also heed the lessons of the Eurozone and not focus on monetary union. The focus should be on trade, investment and infrastructure.

Finally, we come full circle from where we began earlier. Skills development and education are key. Although this is a long term issue where formal schooling is concerned, skills development is not confined to the formal school or academic environment. We need skilled artisans, yet we have far too little by way of apprenticeship training. There remain a significant number of vacancies which, if they were filled, could contribute to economic growth and job creation. This is particularly true at the provincial and local government level where we have seen how the lack of technical skills has impacted on the ability to achieve an adequate level of service delivery in many instances.

None of this is new. All of this has been said before and by many people. The problems of the global economy should be the impetus for action. We need to find ways to minimise the negative impact of the prevailing crisis, and be ready to take advantage of the global recovery when it comes. As we emphasised in our recent monetary policy statement, a sustained increase in the potential output of the economy will require a concerted and coordinated effort from both government and the private sector. Policy consistency and coordination is essential if we are to achieve a growing economy and significantly reduce unemployment.

All of you who are here tonight have significant spheres of influence and a role to play in building cohesion in our society. The future will be what we, all of us, make of it.

Thank you for inviting me to be here with you this evening, and congratulations to all of you who ensure that ORT touches and changes the lives of so many people.