X P Guma: The South African economy and financial markets – outlook, risks and policy responses

Address by Dr X P Guma, Deputy Governor of the South African Reserve Bank, to the South Africa Economic Conference "Business Unusual", Johannesburg, 4 September 2008.

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1. Introduction

Our meeting here today occurs during a period of considerable uncertainty: financial turbulence in the major industrialised economies being the proximate cause of international uncertainty; with a variety of factors impacting upon the short-term indicators of domestic economic performance. It is, therefore, appropriate, I think, to attempt to place recent economic developments in some perspective as this may go some way towards piercing the veil of gloom which appears to have descended over this and other economies. And, for this reason, I thank the organisers of this Conference for according to me the opportunity to participate in these discussions.

2. Overview of key economic indicators: South Africa

In order to assess the South African economy's performance over the medium-term, I have chosen to divide the period from 1990 to 2007 broadly into five-year segments, as indicated in Tables 1A and 1B: namely, the periods 1990-1994; 1995-1999; 2000-2004 and finally, the most recent period 2005-2007.

As these Tables show, real gross domestic product grew at progressively increasing rates throughout this period: from an average rate of 0.2 per cent during 1990-1994 to an average rate of 5.2 per cent during the most recent period. The strongest sectoral growth occurred in the secondary and tertiary sectors, with growth reaching levels, on average, of 5.8 per cent and 5.7 per cent, respectively, over the period 2005-2007.

The economy has become more open with the sum of exports (X) and imports (M) as a percentage of gross domestic product (GDP) increasing progressively, from 40.6 per cent on average, between 1990 and 1994 to 61.6 per cent on average during the period 2005-2007. And inflation, as measured by the Consumer Price Index (CPI), had decreased progressively from an average annual rate of 12.5 per cent in the early period, to an average rate of 5.1 per cent during 2005-2007.[1]

Developments in the financial markets have, in general, been consistent with those described above regarding the real sectors of the economy. Stated briefly, the assets of the banking sector have increased substantially; from a nominal value of R281 billion on average, between 1990 and 1994 to an average of R2 100 billion on average between 2005 and 2007. The average market capitalisation of the bond market has increased, in nominal terms, from an average of R374 billion between 1995 and 1999 to an average of R860 billion between 2005 and 2007. And the average market capitalisation on the JSE Limited has increased from an average of R920 billion during the first of our time periods to an average nominal value of R5 697 billion in the last period.

[1] Data for CPIX became available only during the year 2000.

Moreover, as has been noted elsewhere[2], growth in South Africa's securitisation market has remained relatively healthy since its emergence in 2000. However, this market is subject to cyclical variation to a far greater extent than are others.

In the fairy tale from which the description "Goldilocks" is derived, experimentation by the heroine leads to temporary bliss: not all the plates of porridge were of a temperature that was just right. But one was. And that plate was licked clean – finished, exhausted of its contents. So too, some would have us believe, with the South African economy: it could, apparently, have been described as approximating a Goldilocks economy, with most of the key ratios being "just right"; neither too strong nor too weak; neither too hot nor too cold. Just right or on the way to being just right. Until March 2007.

As explained by Dr M Mnyande[3], Chief Economist of the South African Reserve Bank (the Bank), the first sign of a possible turning point in the business cycle indicator, which is calculated by the Bank, is usually when the composite leading business cycle indicator changes direction clearly for a period of at least six months. And, in March 2007, the leading indicator reached its most recent peak, whereafter it has been following a downward trend. It was also in March 2007 that CPIX, the measure of the rate of inflation that is of interest to the monetary authorities was last within the target range of 6 to 3 per cent which is specified as being the inflation target. Then, global food and fuel price shocks intensified, employment growth abated, real value added in manufacturing contracted as production was hampered by strike activity in the motor industry and slowing demand, *inter alia*. Household debt started to edge higher, the deficit on the current account of the balance of payments widened to 8.1 per cent of gross domestic product in the third quarter of 2007 – the highest ratio since the 9.2 per cent registered in the first quarter of 1982. And then in January 2008 power cuts disrupted output and exports, taking the public by surprise. Or stated in such a way as to complete the analogy, at some time during or around March 2007 Goldilocks jumped up and ran away … and has not yet returned.

3. The International financial environment

According to the Quarterly Review of the Bank for International Settlements (BIS) issued on 1 September 2008;

> "… During the period from end-May to late August 2008, global financial markets adjusted to growing signs of a broad-based cyclical deterioration.
>
> While markets continued to display signs of fragility, worries about the economic outlook and related uncertainties gained prominence, weighing on valuations across asset classes.
>
> Credit markets came under renewed pressure over the period, as spreads widened to reflect the implications of the ongoing cyclical adjustment for loss expectations and financial sector balance sheets. This was despite retreating oil and commodity prices, government action in support of the US housing market and continued recapitalisation efforts by banks and other financial firms. Equity markets reflected similar concerns, as valuations adjusted to reflect disappointing earnings data, including in the financial and other cyclical sectors. Against this background, pressures in interbank money markets persisted, prompting further central bank action to ease financial sector access to funding." (p.2)

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[2] A.D. Mminele. (2008) "Benefits and Risks of New Instruments: Derivatives and Securitisation; the case of South Africa", Berlin, 4 July 2008. Conference on Financial Innovation and Emerging Markets.

[3] Dr Monde Mnyande (2008) "Keynote address at the 4th Convention of the South African Institute of Black Property Practitioners (SAIBPP)", Helderfontein Conference Centre, July 31.

The origins of this turbulence, turmoil and distress in the international financial markets are well known and need not detain us unduly.[4] As summarised in the Annual Report 2007 of the Bank Supervision Department of the Bank, the episode began with credit concerns in the United States (US) sub-prime mortgage market, in 2007; and developed into concerns in global credit markets as the extent of exposures and potential losses from the sub-prime market were not known.

Then,

> "… The ongoing boom in the US housing market attracted clients who would not normally have qualified for loans. Loans granted to these clients are commonly known as "sub-prime mortgage loans". In some instances the sub-prime loans were offered at initial low "teaser" rates, which reset to higher rates after a few years. As these loans began to reset and the housing market began to cool off during 2006 (i.e., growth in house prices decreased), these clients found themselves unable to meet the higher payment obligations and were not able to refinance their loans. It was during this period that non-performing sub-prime mortgage loans increased rapidly."
>
> "Concurrent with the granting of sub-prime mortgage loans, certain institutions securitised their mortgage loans. Numerous methods and instruments were developed to facilitate this process, and the instruments became increasingly complex. Instruments such as mortgage-backed securities and collaterised debt obligations offered tranches of risk, ranging from high-risk equity tranches to low-risk senior tranches. As a result, a wide range of banks and investors faced significant exposure, directly and indirectly, to the US sub-prime mortgage market." (p.3)

At the time of writing, the impact of the US sub-prime crisis on the prospects for the international economy are difficult to assess: not least because of the rate at which the losses which have been incurred by major financial institutions are being reported. However, from media reports, it would appear that Bloomberg's calculations of write downs by and credit losses of banks related to the sub-prime crisis, at approximately US$400 billion, provide a plausible threshold. These estimates are reproduced in Table 2, below.

What is clear is that prolonged financial-market turmoil in the major industrialised economies of the world would impact adversely on economic and financial stability generally, making prospects for a resumption of robust and sustained economic growth in South Africa more uncertain. So too with an attenuation of the processes currently underway to reduce the imbalances which are extant in the global economy through unchanged or increased protectionism, reluctance to permit currencies to appreciate (or depreciate) in accordance with economic fundamentals.

In short, prospects for the international economy are served poorly by a generalised failure by policy makers to acknowledge, by praxis, a simple fact: namely, that a globalising economy is, was and will remain a closed system. Its imbalances cannot, as yet, be exported (or transported) elsewhere.

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[4] See, for example:
Bernanke, B.S. (2007) "Housing Finance and Monetary Policy", Speech at the Federal Reserve Bank of Kansas Economic Symposium, Jackson Hole, Wyoming: 31 August.
IMF (2008) Global Financial Stability Report, Washington D.C.

4. Some considerations regarding policy

My discussion of policy will be brief for two reasons. First, because the bulk of the effort of this Conference will be devoted to this matter: and second, because the subtitle of the Conference is: "Business Unusual".

According to President Thabo Mbeki, to whom authorship of this phrase is ascribed, "Business Unusual" does not refer "… to any changes in our established policies…"; rather it refers to "… the speedy, efficient and effective implementation of these policies and programmes, so that the lives of our people should change for the better, sooner rather than later." So, to use the idiom of the contemporary policy analyst, we can assume that the policy thing has been parameterised: in the form of the RDP (1994); GEAR (1996); the Growth and Development Summit (2003) and the Asgisa (2005).

My only caution is that in proceeding, sight should not be lost of the fine balance that needs to be maintained between the state and the market as the primary allocator of resources. For, as Schumpeter observed[5], when the state is pre-eminent and its shortcomings are highly visible, economists and others seem to swoon over the charm of the market. But when the market is in the ascendancy and its drawbacks are evident, then the state may be idealised. Both extremes should be resisted.

5. Conclusion

Let me conclude by making the following observations. First, fairy tales have a useful function to perform in entertaining children – but are of dubious value in enhancing discussions of economics. Goldilocks and her kindred spirits should, please, be allowed to go away from the pages of economic analysis.

Second, any notion that the South African economy is soon to enter a recession[6] must be rejected, firmly. The current growth rate of the economy may be somewhat lower than had come to be expected but is still strongly positive and will remain so. The so-called "tsunami" of adverse economic outcomes in the period subsequent to March 2007 will lose momentum as inflation abates, the balance between aggregate saving and investment improves, the process of financial deepening intensifies and better use is made of the potential for capture of resource rents in the current commodity cycle.

Third, whilst South Africa has been spared, along with many other emerging markets, the worst of the financial market turmoil, the authorities have not become complacent. Adherence to a clearly articulated macro-economic framework, which includes an explicit inflation-target, provides the first line of defence – in particular, against capital flight. A second line is drawn by ensuring adherence to international best standards on laws, regulations, practices and policies in the financial sector; monitoring proven financial soundness indicators for early warning of potential problems. And a third line is drawn by the Financial Sector Contingency Forum – which I currently chair. This is a forum which facilitates inter-agency coordination and preparedness for addressing crises.

Finally, I think that South Africa should continue to participate fully in international fora in order to make the case for multi-lateral adjustments in the interests of systemic stability in our closed system. Continued myopia by national governments will, likely, prolong the

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5 See Schumpeter, J.A. (1949) "English Economists and the State-Managed Economy", Journal of Political Economy, 57, no. 5.
and also
Klitgaard, R. (1991) Adjusting to Reality: Beyond "State versus Market in Economic Development, San Francisco, I CE G.

6 "Recession" here means a classical recession: i.e., a period of economic contraction or negative growth sustained for 2 quarters or more.

adjustment process which needs to be completed if the current turbulence in financial markets is to be resolved.

And on that note, I end: thank you for your attention.

References:

1. Bernanke, B.S. (2007) “Housing Finance and Monetary Policy”, Speech at the Federal Reserve Bank of Kansas Economic Symposium, Jackson Hole, Wyoming: 31 August.

2. BIS (2008) Quarterly Review, Basel.

3. IMF (2008) Global Financial Stability Report, Washington D.C.

4. Klitgaard, R. (1991) Adjusting to Reality: Beyond “State versus Market in Economic Development, San Francisco, I CE G.

5. Mminele, A.D. (2008) “Benefits and Risks of New Instruments: Derivatives and Securitisation; the case of South Africa”, Berlin, 4 July 2008. Conference on Financial Innovation and Emerging Markets.

6. Mnyande, M. (2008) “Keynote address at the 4th Convention of the South African Institute of Black Property Practitioners (SAIBPP), Helderfontein Conference Centre”, July 31.

7. Schumpeter, J.A. (1949) “English Economists and the State-Managed Economy”, Journal of Political Economy, 57, no. 5.

8. South African Reserve Bank (2008) Annual Report 2007: Bank Supervision Department, Pretoria.

Table 1A: Key economic indicators: 1990 - 2007

Average growth rate over period **Real Sector**	**1990 - 1994**	**1995 - 1999**	**2000 - 2004**	**2005 - 2007**
Gross domestic product	0,2	2,6	3,7	5,2
Primary sector	0,0	-0,3	1,1	0,1
Agriculture	0,4	1,2	1,5	-0,7
Mining	0,3	-0,8	1,0	0,5
Secondary sector	-1,1	2,0	3,6	5,8
Manufacturing	-1,5	2,2	3,5	4,5
Electricity, gas and water	2,8	2,0	1,6	2,6
Construction	-2,8	0,4	6,9	15,0
Tertiary sector	0,9	3,5	4,3	5,7
Commerce	-0,1	3,8	4,9	6,4
Transport and communication	1,3	7,0	6,8	5,2
Financial and other services	1,3	4,5	5,9	7,4
Gross domestic expenditure	0,4	2,1	4,7	7,0
Consumption	1,3	3,4	4,2	7,4
Investment	-1,6	4,3	5,9	12,5
Government	1,7	-0,4	4,6	5,0
Inflation (CPI)	12,5	7,4	5,5	5,1
Unemployment rate		21,2	28,2	25,5
Trade openness (X + M)/GDP	40,6	47,8	55,8	61,6
Current account deficit to GDP	1,2	-1,3	-0,7	-5,9
International liquidity position in US$ Millions[1] (end of year averages for period)	-16947	-17594	-56	23825
Interest rates (Prime lending) (yearly avg)	18,39	19,39	14,09	11,63
Banking sector assets (end Dec)				
R billions (Average of Dec values)	281,1	559,9	1 170,9	2 099,9
Average of Dec year-on-year % changes	11,4	16,1	15,9	19,5
Bank credit extension (yearly avg)				
R billions (Average of monthly values)	185,1	378,1	648,8	1 225,1
Average of monthly year-on-year % changes	13,5	15,9	10,7	23,7
Capital markets				
All share index (avg. of end of period data)		6 075	9 364	21 660
All share index (growth – per cent)[2]			54	131
Turnover shares(total – R billions)[3]	164	1 155	3 735	6 380
Turnover shares (growth – per cent)	137	604	223	71
Turnover bonds (total – R billions)		26 589	56 617	39 663
Turnover bonds (growth - per cent)			113	-30
Market capitalisation bonds (end of period – R billions)		374	662	860
Market capitalisation bonds (growth – per cent)			77	30
Market capitalisation shares (end of period – R billions)	920	1 616	2 566	5 697
Market capitalisation shares (growth - per cent)	85	76	59	122
Public finance				
Budget bal to GDP(deficit+ surplus-)	-4,0	-4,3	-1,8	-0,2
Debt to GDP	38,6	49,1	41,9	31,1

Source: South African Reserve Bank

Table 1B: Key economic indicators: 1990 - 2007

Average contribution to nominal GDP	1990 - 1994	2005 - 2007
Nominal Sector	**Per cent**	
Primary sector	12,3	10,6
Agriculture	4.3	3,0
Mining	7,9	7,6
Secondary sector	28,8	23,5
Manufacturing	21,9	18,4
Electricity, gas and water	3,7	2,4
Construction	3,2	2,7
Tertiary sector	58,9	65,9
Commerce	14,2	14,0
Transport and communication	8,7	9,4
Financial and other services	15,4	21,8
Average contribution to nominal GDE		
Final consumption expenditure by households	64,4	60,8
Gross Fixed Capital formation (Investment)	16,8	18,4
Final consumption expenditure by general government	20,8	19,1

Source: South African Reserve Bank

Table 2: Sub-prime losses (net of financial hedges used to mitigate losses) as at 18 June 2008[1] (Billions of US dollar)

Firm	Writedowns and losses	Writedowns and losses as % of total	Capital raised
Citigroup	42.9	10.8	44.1
UBS	38.2	9.6	28.6
Merrill Lynch	37.1	9.4	17.9
HSBC	19.5	4.9	3.5
IKB Deutsche	15.9	4.0	13.1
Royal Bank of Scotland	15.2	3.8	24.0
Bank of America	15.1	3.8	20.7
Morgan Stanley	14.1	3.6	5.6
JPMorgan Chase	9.8	2.5	7.8
Credit Suisse	9.6	2.4	1.5
Washington Mutual	9.1	2.3	12.1
Credit Agricole	8.3	2.1	9.1
Lehman Brothers	8.2	2.1	13.9
Deutsche Bank	7.6	1.9	3.2
Wachovia	7.0	1.8	10.5
HBOS	7.0	1.8	7.8
Bayerische Landesbank	6.7	1.7	-
Fortis	6.6	1.7	1.0
Canadian Imperial (CIBC)	6.5	1.6	2.9
Barclays	6.3	1.6	9.7
Societe Generale	6.2	1.6	10.1
Mizuho Financial Group	6.0	1.5	-
ING Group	6.0	1.5	4.9
WestLB	4.9	1.2	7.7
LB Baden-Wuerttemberg	4.0	1.0	-
Goldman Sachs	3.8	1.0	0.6
Dresdner	3.4	0.9	-
Natixis	3.4	0.9	0.8
E*Trade	3.3	0.8	1.8
Wells Fargo	3.3	0.8	4.1
Bear Stearns*	3.2	0.8	-
National City	3.1	0.8	8.9
Lloyds TSB	2.7	0.7	-
Landesbank Sachsen	2.7	0.7	-
BNP Paribas	2.7	0.7	-
HSH Nordbank	2.5	0.6	-
Nomura Holdings	2.4	0.6	1.2
ABN Amro*	2.4	0.6	-
DZ Bank	2.1	0.5	-
Bank of China	2.0	0.5	-
Commerzbank	1.9	0.5	-
Rabobank	1.7	0.4	-
Bank Hapoalim	1.7	0.4	2.6
Royal Bank of Canada	1.6	0.4	-
Mitsubishi UFJ	1.6	0.4	-
UniCredit	1.6	0.4	-
Alliance & Leicester	1.4	0.4	-
Fifth Third	1.4	0.4	2.6
Dexia	1.3	0.3	-
Caisse d'Epargne	1.2	0.3	-
Hypo Real Estate	1.0	0.3	-
Gulf International	1.0	0.3	1.0
Sovereign Bancorp	0.9	0.2	1.9
Sumitomo Mitsui	0.9	0.2	3.1
Sumitomo Trust	0.7	0.2	1.0
Keycorp	0.6	0.2	1.7
DBS Group	0.2	0.1	1.1
European banks not listed above **(a)**	6.1	1.5	2.4
Asian banks not listed above **(b)**	4.5	1.1	6.4
North American banks not listed above **(c)**	3.8	1.0	1.3
TOTAL**	**395.8**		**302.1**

Source: Bloomberg (www.bloomberg.com)