Gill Marcus: Recent global developments and their implications for South Africa

Comments by Ms Gill Marcus, Governor of the South African Reserve Bank, at a Power Business Breakfast function, Johannesburg, 7 July 2010.

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The global economy is at a crossroads. The world is in the midst of significant change, and the events in Europe are the most vivid examples of how complex and difficult the current environment is. The previous euphoria that the recovery was well underway has now translated into greater caution.

Last week saw an almost synchronised decline in PMIs around the world, with the slowdown in manufacturing taking place more quickly than previously anticipated.

While some analysts now see a double dip as a likely scenario, even the more optimistic who have retained a positive outlook now have a downside risk built into their forecasts, or greater "fat tail" risks.

The reality is that we probably never really emerged from the crisis, which is now entering its next phase.

These developments have serious implications for the domestic growth outlook.

The global economy

Until recently there had been a progressive upgrading of growth forecasts. For example, in the April *World Economic Outlook*, the IMF exemplified what can be regarded as the perceived wisdom:

- that the recovery was proceeding faster than expected;
- that the recovery would be uneven but would proceed;
- that exit strategies from expansionary monetary and fiscal policy would be required, and
- that these should be done carefully so as not to upset the recovery.

It soon became evident that the extent of the required fiscal consolidation would be much more significant than initially thought: the explosion of fiscal deficits and debt ratios, that were seen to be part of the initial solution to the crisis, was now seen as a problem, as both solvency and sustainability issues came to the fore.

The *Secular Outlook* of May 2010 issued by PIMCO's Mohamed El-Erian, stated that "the drama paying out in Europe (includes) … the generalised and simultaneous nature of the debt explosion in industrial countries, the application and content of regulatory initiatives across the globe, the headwinds to job creation in some industrial countries, the extent of political polarisation and … the further shift of growth and wealth dynamics to emerging economies…"

It also became clear that in a number of countries and regions growth was dependent on the continued stimulus provided by the fiscal and monetary authorities. Initially fiscal expansion was required to fill the gap left by the collapse in private sector demand. However, the private sector, particularly in the advanced economies, was not ready to step back in to support domestic demand, largely because of impaired balance sheets.

Households remain cautious, and the initial driver of the recovery – inventory adjustments – cannot continue indefinitely without a recovery in domestic demand. The withdrawal of the fiscal stimulus in the US is therefore coming at an inopportune time.

In some countries, eg in Europe, the approach has moved beyond mere fiscal stimulus withdrawal, as in the US, to one of fiscal austerity or consolidation. These measures, while necessary from a sustainability point of view, are coming at a time that is in effect premature, and could well undermine the pace of recovery further. For example, it has been estimated that an attempt by the Greek government to reduce its budget deficit over the next three years by the 10 percentage points of GDP needed to bring that deficit into line with the Maastricht criteria could cause GDP to decline over the next few years by between a cumulative 15 and 20 percent.

The process of fiscal consolidation will place most of the burden of adjustment on monetary policies. In effect, we are likely to have low interest rates globally for much longer than previously thought. These low interest rates will counteract the negative growth impact of the fiscal consolidation.

Furthermore, central banks will, in all likelihood, need to continue to use their balance sheets to help support the financial markets.

The PIMCO *Secular Outlook* has described the crisis as one of serial balance sheet contamination. It started off with private sector balance sheets being expanded unsustainably (households and banks). With too many balance sheets deleveraging simultaneously, threatening global depression, governments were forced to step in with their balance sheets which led to the current sovereign risk issues. Now fiscal authorities have to deleverage, leaving the monetary authority balance sheets as the only ones left to prevent a downturn. At a regional level, it is the German balance sheet that is bailing out the rest of Europe.

There are concerns that this implies inflationary pressures down the line. Given the size of output gaps, it is probably premature to be concerned about inflation at this stage in the advanced economies, but there are limits to what can be done by monetary policy on its own. There is also the risk of temptation to solve debt crises through monetisation.

All this is also playing out in the political terrain, and social contracts are coming under considerable stress. Nowhere more so than in Europe where the social fabric in a number of countries is coming under strain as people are being asked to pay the price of the adjustment in terms of either lower wages, or in terms of their jobs.

This is occurring at a time when elections are resulting in an increasing number of weak coalition governments, reflecting a lack of social consensus on the way forward.

The obvious solution, namely to grow out of the crisis, is not that easy as growth is likely to remain lower for longer.

Strategies for dealing with unemployment, particularly in Europe, are creating further problems. For example, the extension of the working life of individuals in a number of countries, while helping with the demographic problems of dealing with an ageing population, is leading to more youth unemployment. In Spain the unemployment rate is 20 per cent, but youth unemployment is closer to 40 per cent. There is a real danger of young people remaining unemployed for some time to come, resulting in deeper structural and social problems.

Europe remains the biggest area of concern:

The weaknesses of the fixed exchange rate system have been exposed. It is not enough to have currency union, as there has to be a credible fiscal union as well, with enforceable limits. While there was growth, the decline in competitiveness in the peripheral European countries could be papered over, and the burgeoning fiscal and current account deficits could

be financed, provided that the sovereign debt of these countries was seen to be of the same risk category as the core countries.

But that has changed in a dramatic way, although it was surprising that it took the downgrades by the rating agencies to get the markets to react to something that had been evident for some time.

The fiscal adjustment in Europe and the UK means that growth is going to be very low for some time, perhaps not even in positive territory. However, some countries may have stronger growth, eg Germany, if they do not require much fiscal adjustment, and are able to increase productivity and take advantage of the weaker euro.

In the US, consumption expenditure is not recovering at the pace initially expected, as high levels of unemployment, a de-leveraging banking sector and a weak housing market remain a constraint on households still faced with excessive debt.

China and the Asian region in general, as well as some countries in South America, are seen as the main growth poles. However, there are signs that the policy-induced slowdown in China is having some effect.

The latest forecasts are for growth of "only" 9 per cent. While a policy to cool down the Chinese economy was envisaged at the beginning of the year, at that stage it was not seen as a threat to the global picture given the expected rebound in the global economy. The fact that this cooling down is taking place at a time of a more general slowdown has reinforced the increasingly negative global outlook.

The growth outlook is also affected by the slow banking sector recovery, and uncertainty related to regulatory reforms. The need for higher capital adequacy, de-leveraging and increased liquidity requirements could also discourage lending. At the same time, a downturn in growth will also impede the banking sector recovery.

The South African outlook

Given this very challenging global environment, what are we observing in South Africa? The recovery is taking place, but it is hesitant, fragile and uneven. Its sustainability will be dependent on the global recovery in general and in Europe in particular, which is the destination for about one third of our manufactured exports, as well as how effectively we use those opportunities that are there to enhance our economic infrastructure and human capital capacity.

Although our exposure to the Southern European countries (Greece, Italy, Portugal and Spain) is relatively small – approximately 5 per cent of our exports – Europe as a whole accounts for about one third of our manufactured exports. A slowdown in the euro area as a whole will not be inconsequential for South African exports.

We appear to have become a 4.6 per cent economy:

- First quarter GDP growth measured 4.6 per cent (seasonally adjusted and annualised);
- the current account deficit measured 4.6 per cent in the first quarter; and
- the May CPI inflation rate measured 4.6 per cent.

Although growth has improved, the output gap remains wide, and it will take some time to get back to pre-crisis levels of output.

While the growth outlook remains positive, our growth is expected to remain much slower than that in many other emerging markets. In recent days, a number of analysts have also downgraded their quarterly growth forecasts for this year in the light of global developments

and the weaker PMI. Nevertheless we still expect growth to average around three per cent in 2010.

The manufacturing sector has led the recovery since the second half of last year, mainly a result of an export recovery. The outlook therefore depends on the global prospects. Unfortunately the most recent data shows that manufacturing may be slowing down, and the PMI is down at 48.4, the fourth consecutive monthly decline, indicating a possible contraction going forward. This poses a risk to the growth outlook for the rest of the year.

Gross fixed capital formation turned positive in the first quarter of 2010, but only marginally so (0,2 per cent), driven mainly by public corporations. Of concern is the continued contraction of private sector investment.

Household consumption expenditure appears to have improved and turned (weakly) positive (1,6 per cent) in the final quarter of 2009, after five consecutive quarters of negative growth. In the first quarter it measured 5,7 per cent quarter-on-quarter annualised, though some moderation may be expected. This is also reflected in the credit extension numbers, which although remaining low, recently turned positive.

The inflation outlook remains favourable: in May it measured 4,6 per cent, and we expect inflation to remain within the target range for the remainder of the forecast period, but our forecasts are that it will begin to rise moderately by the fourth quarter of 2010. This outlook has enabled us to reduce the repo rate to its lowest level in nominal terms at 6,5% since the late 1970s.

Unfortunately, despite positive growth, employment continues to lag. This is not unusual in the early phases of the cycle, but there are other factors that seem to indicate that the pick-up in employment is likely to be slow. We lost a disproportionately large number of jobs during the crisis compared with other countries, but despite this, wage settlements remain well above inflation, particularly in the public sector. If this is not matched by improved productivity there are likely to be inflationary consequences.

The public protests seen abroad in Greece and elsewhere do not reflect the same demands ie for higher wages. In Europe the protests are against losing jobs, and the severe austerity measures that have been introduced to reduce double-digit sovereign debt.

South Africa cannot, on the one hand, put employment creation as its priority, and then at the same time demand (and agree to) wage and salary increases that are, in some instances, double the level of inflation.

In this regard the behaviour of management is critically important. Outrageous increases or bonuses are simply not acceptable. Management has to lead by example. According to *Computus*, a forensic accounting firm, executive pay has increased notwithstanding the financial crisis and global recession. In its sample of 326 listed companies and parastatals, it reports that CEO remuneration increased by 11,5% on average from 2006 to 2009.

South Africa as a whole needs to have a greater understanding of the global financial crisis and its consequences for all of us. This requires greater interaction and a common purpose determining the appropriate course of action that we, as a nation, need to take to stave off the worst ravages of the crisis.

We have experienced the most remarkable period of togetherness in the past month, built around Soccer 2010 and being host to the world, both the hundreds of thousands who have come in person, and the millions who have watched on TV and other media. We need this togetherness and sense of what we can achieve to continue beyond the world cup, and to permeate other aspects of society.

There also needs to be greater coordination and cooperation between policies. It is not possible to have loose monetary policy and loose fiscal policy and a weaker exchange rate. This will not translate into a depreciated real exchange rate. Rather, it is a simple recipe for higher inflation. We need an appropriate mix or combination of both macroeconomic and

microeconomic policies that will bring about higher productivity, higher growth and employment in a low inflation environment.

Today, what is clear is that central banks the world over have been given additional responsibilities, explicitly or implicitly. Expectations are that central banks will, and can, deal with macro-prudential, micro-prudential, financial stability, crisis management, provision of liquidity and still meet their core responsibility, namely independent execution of monetary policy.

Financial stability crises build up over years, and what the prevailing global crisis has shown is that it is much harder to restore financial stability once it has been lost than previously anticipated. Another lesson is that there is an increasing need for co-ordination and co-operation between central banks, governments and markets, within a sound regulatory environment and with a focus on maintaining systemic stability.

In conclusion, what we are seeing is a bifurcated world where the developed countries face gradual de-leveraging with lower growth for longer in a more regulated environment, impacted upon by severe austerity measures and poor public finances. Furthermore, the US faces increasingly large structural headwinds, including deteriorating public finances, while the Eurozone is likely to see low inflation for some time to come.

On the other hand, key emerging countries such as China, India and Brazil, seem set to continue to grow and develop. Our challenge is to ensure that South Africa, with so much going for us, is one of these key emerging countries.