Gill Marcus: Perspectives on recent global economic developments

Address by Ms Gill Marcus, Governor of the South African Reserve Bank, to the US Chamber of Commerce in South Africa, Johannesburg, 23 August 2011.

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Good morning and thank you for the invitation to address this meeting of the US Chamber of Commerce in South Africa. We meet at a challenging time, with the global economy moving perilously close towards a precipice, as the financial crisis moves into its fifth year. Recent developments underline just how central the role of the US economy in the global economy remains. The current global outlook is therefore highly dependent on the health of the US economy, which is also important from a local perspective as the US is one of South Africa's main trading partners, with a positive trade balance in South Africa's favour. In 2010, almost 9 per cent of our total exports, totaling R52 billion, went to the US, while around 7 per cent of our imports, valued at R42 billion were sourced in the US.

A number of recent developments have resulted in a high degree of market turbulence in recent weeks. These include the realisation that the outlook for US growth is not as favourable as previously believed, the damaging US debt ceiling debate and the consequent ratings downgrade of US debt, and the further deterioration of the European sovereign debt crisis which has now spread from the periphery to the core, and potentially to the European banking system.

What started in 2007 as a banking crisis related to the US housing market has turned into a sovereign debt crisis, and recent events in the US and Europe illustrate how quickly the crisis can mutate. At the heart of the problem is a lack of strong unified and credible leadership, leading to a loss of confidence and trust in this leadership and potentially in the system as a whole. Behind the statistics are real people who find their lives in turmoil and livelihoods and future ambitions at risk. And in these circumstances those presenting easy answers to what are very complex and difficult issues can readily gain support.

Given the backdrop against which we are meeting, it would be appropriate to make some comments about the current global developments and their possible implications for Africa in general and South Africa in particular. It would also be useful to draw out some of the lessons for Africa from the problems being faced by the Eurozone.

What we are witnessing currently is not a new crisis, nor is it part of a normal economic cycle. We can learn a lot from the work of Reinhart and Rogoff who have shown that unlike normal economic cycles or recessions, financial crises are protracted affairs. According to their research, conventional recessions involve a relatively quick return to normalcy, and generally the economy makes up the lost output and resumes its pre-recession growth trend within a year. A recession involving a financial crisis involves not only loss of output and employment but applies to debt, credit and the deleveraging, which takes much longer to work through. Their work shows that the aftermath of severe financial crises share three main characteristics: that asset market collapses are deep and prolonged; that such crises are associated with profound declines in output and employment, with the latter being particularly protracted; and the real value of government debt tends to explode, on average almost doubling over a short period. This debt increase is apart from possible banking bailout costs, and is a result of an inevitable collapse in tax revenues as well as countercyclical expenditure policies. Their findings also not only show that banking crises do not discriminate between emerging markets and developed markets – leading them to label such crises as equal opportunity menaces – but developed countries generally take much longer to recover than emerging markets, possibly due to greater wage flexibility in (some) emerging markets.

Normal cyclical downturns are often reinforced by tight monetary policies in response to an overheating economy and inflationary pressures, and the downturn can be effectively moderated by a reversal of the monetary policy stance. Unfortunately we are not in a normal cyclical downturn, and the crisis cannot be solved through monetary policy alone. Households in the advanced economies are still in the process of deleveraging and repairing their impaired balance sheets, and monetary policy can only help to a certain extent. In the context of low and falling house prices, declining equity prices and stubbornly high unemployment, rebuilding of household balance sheets may take a protracted period.

The problem facing the US currently is this uncertainty relating to the self-sustainability of private sector consumption expenditure. At the start of the crisis, the gap left by the consumer, usually the main driver of growth, was filled in part by increased government expenditure. By the beginning of 2010 the recovery appeared to be underway and the consensus view was that by mid-2010, the US economy would be on a self-sustaining recovery path, and the focus then was on exit strategies or normalization of both monetary and fiscal policies. By mid-2010 it had become apparent that this positive outlook was misplaced, and an additional fiscal stimulus, in the form of the extension of the Bush-era tax cuts followed, along with a further round of quantitative easing. The result of this, however, was a further build-up of public leverage.

There were concerns, however, that the impact of this additional stimulus would disappear by the middle of this year, and that consumption expenditure would not yet be on a self-sustaining path. The slowdown in the US economy in the first half of the year was widely interpreted as a temporary soft patch, attributed in the main to supply chain issues relating to the disasters in Japan. There is now a more general recognition that the US economic recovery is weaker than anticipated, and fears of a possible return to recession have replaced the earlier confidence. This is particularly the case after the significant downward revision of US growth performance in the first quarter of 2011 from 1,8 per cent to 0,4 per cent. The announcement by the FOMC that the policy rate in the US is likely to remain accommodative until mid-2013 is more a statement about the weak outlook for the US economy, and the structural nature of this weakness, rather than a commitment about interest rates.

Unfortunately the outlook is no better in the UK and the Eurozone. For some time the focus has been primarily on the sovereign debt problems of the peripheral European economies. As suggested by Reinhart and Rogoff, there has indeed been a spiraling of indebtedness of many Eurozone economies. For example, the debt to GDP ratio in Spain is expected to have increased from 40 per cent in 2008 to an estimated 75 per cent in 2012, while that of Greece from 105 per cent to 166 per cent over the same period. Fears of default abound as the different European countries failed to make the difficult decisions about burden sharing between countries and the private sector. Policy pronouncements and packages have not been fully followed through, or have generally disappointed the market in their failure to fully deal with the problems. Countries such as Greece have been forced into austerity programmes which are likely to be either politically unsustainable, or if they do manage to achieve the proposed expenditure reductions, may result in declines in real growth rates which would then reinforce the negative debt dynamics. The recent announcement by the Greek Finance Minister that Greece is expected to contract at a worse-than-expected 4,5 per cent or above in 2011 is a case in point. Debt sustainability is, after all, partly a function of both the cost of servicing the debt as well as the real growth rate of the economy. As the markets reassessed the ability of a number of countries to consolidate their fiscal positions, the spreads on sovereign debt increased, which in turn undermined the sustainability criteria.

The failure of the Eurozone economies to deal decisively with the issue has resulted in a spill-over to the broader region, with the focus leap-frogging firstly Spain and then both Spain and Italy, and on to France, where the markets are now questioning the sustainability of the country’s AAA rating. The interconnected nature of these economies is reinforced by the exposure of the banks in France and Germany in particular to the debt of the peripheral European economies. The IMF estimates that the European banks’ exposure to the

European periphery constitutes around 10 per cent of Europe's GDP and about 80 per cent of the capital of European banks.

In effect we have seen a banking crisis turning into a sovereign debt crisis, which in turn has the potential to undermine the banking sector recovery in Europe. In recent weeks there have been reports of US money market funds reducing their exposures to European banks. Bank equity prices have come under pressure, and interbank rates have also widened somewhat. Banking systems rely on confidence, and a collapse of confidence relating to counter-party risk can easily cause a liquidity crisis to translate into a solvency crisis with negative feedback effects to the real sector of the economy. For this reason it is important for central banks to stand ready to support their banking systems by providing appropriate liquidity support if and when required. Fortunately, central banks are probably better prepared for such actions than was the case in 2008.

As the financial crisis gathered momentum in 2008, a feature that was widely recognised was the synchronised nature of the downturn. Current developments are disturbingly similar, with evidence of a synchronised downturn in many of the advanced economy. It is unclear at this stage if a reversion to recessionary conditions is likely, but at best the advanced economies appear to be in a stalled state. Even Germany, which until recently had been the powerhouse of Europe, only managed growth of 0,1 per cent in the second quarter of this year, while the Eurozone as a whole averaged 0,2 per cent. Growth in the UK is also expected to be 0,2 per cent, and 4 per cent below the pre-crisis peak. This raises serious concerns for two main reasons. First, there will inevitably be an impact on growth in the rest of the world. In 2008 the hopes of decoupling by emerging markets proved to be vain ones, and while there does appear to be an increased amount of intraregional trade, in Asia in particular, it is almost inevitable that the rest of the world will not escape unscathed. Second, a general growth slowdown will exacerbate the debt dynamics in many of these countries, and may indeed reinforce these negative dynamics if further fiscal stimulus is provided.

So what can be done? The cumulative nature of this crisis means that many parts of the world have reached this stage having sold off most of the family silver. In 2008, the coordinated response by many countries resulted in fiscal and monetary policy reactions which are simply not possible this time round. The response at this stage has been limited as governments generally face fiscal consolidation, and their room for manoeuver appears to be constrained.

In most of the advanced economies, monetary policy remains extraordinarily accommodative. As interest rates in many of these countries are close to the zero bound, the scope for further reductions is limited apart from further quantitative easing and actions to provide liquidity or support to dysfunctional segments of the financial markets. There is no doubt that the burden of the policy response will fall disproportionately on monetary policy, but it is unclear if such actions will be effective in providing additional stimulus as opposed to simply facilitating the functioning of markets.

The lack of fiscal space creates a real policy dilemma. On the one hand countries require a fiscal stimulus to try and counteract the slowdown, while on the other hand the inevitable further build-up of debt means that sustainability issues become paramount. So there is the conflict between short term exigencies and longer term sustainability issues. Ultimately the policy focus has to be on growth, which will help with fiscal sustainability, rather than on debt reduction in the short run. There needs to be a clear distinction between short and medium term needs, with a clear commitment to medium and long term fiscal sustainability. The focus should also be on fiscal initiatives that have a durable growth-enhancing capacity and structural reform, and not simply fiscal impulses for their own sake.

Unfortunately this is easier said than done. In order to avoid a replay of 2008, there needs to be a cohesive understanding of the situation, and a unity of purpose at the global and national levels. An effective response requires confidence and trust in leadership, and this appears to be lacking. The fractious nature of political processes seems to be making it difficult to have the level of coordinated and purposeful responses that the crisis demands. This is well illustrated by the debt-ceiling debacle in the United States, where some factions were willing to take the country and indeed the world over the brink. Similarly, the inability of the leadership on the Eurozone economies to agree on a credible and durable solution for the region has undermined support not only for the leadership but for the whole Eurozone project.

Until now, there have been piecemeal responses to the European crisis, which have merely delayed the need for a credible solution. There are no easy or painless solutions, but the longer they are delayed, the more difficult and painful the outcome will be. It is not just the markets that have lost confidence, it is the ordinary people who are bearing the brunt of the consequences of the crisis. These social and the social consequences are becoming increasingly apparent and disturbing with a growing structural unemployment problem, particularly amongst the youth in some countries, and in a number of instances, increased civil unrest.

The South African economy will not be immune to these developments. The economy has made a fragile and uneven recovery from the recession, but the future growth prospects will be affected significantly by global developments. Favourable growth outcomes were achieved in the final quarter of 2010 and the first quarter of 2011, when annualised growth rates of 4,5 per cent and 4,8 per cent respectively were recorded. However the second quarter performance had been disappointing, with both the manufacturing and mining sectors likely to have subtracted from growth. The main driver of growth over the past quarters has been growth in household consumption expenditure, which has averaged around 5 per cent since late 2009. However, for some time the Monetary Policy Committee of the Bank has questioned the sustainability of this consumption growth given the slow pace of employment growth, high levels of consumer indebtedness, low levels of bank credit extension as well as negative wealth effects emanating mainly from the weak housing market. Recent retail sales developments indicate that there may be some slowdown in the growth of household consumption expenditure.

A worrying feature of the domestic recovery has been the slow growth of gross fixed capital formation, particularly by the private sector. This may be due in part to the relatively low levels of capacity utilisation in manufacturing, and the unfavourable export climate, due in part to slow growth in Europe, and declining competitiveness due to a relatively strong exchange rate and high rates of domestic input cost increases (including wages and electricity). South Africa’s export recovery has not been as robust as that in other emerging markets, and much of the increase in export values has been due to higher global commodity prices. The main destination for South Africa’s manufactured goods remains Europe and the United States, so a prolonged slowdown in these regions will have negative implications for the country’s exports. Should a more generalised slowdown transpire, we could see a decline in commodity prices as well.

The low interest rate environment in the advanced economies has resulted in elevated levels of capital flows to emerging markets, in search of higher yields, with consequences for both the level and volatility of the rand exchange rate. There has, however, been a change in the pattern of these flows, which are now predominantly into bond markets rather than into equity markets. In South Africa, for example, since the beginning of 2011, non-residents have been net purchasers of bonds to the value of R51 billion, but have been net sellers of equities to the value of R8 billion. Given the prospects for a protracted period of low interest rates in the advanced economies, these flows are expected to continue, although are likely to become more volatile and uncertain during episodes of heightened risk aversion.

Monetary policy has remained relatively accommodative in response to these developments. The policy rate, at 5,5 per cent, is at its lowest levels in 30 years, and the real policy rate is around zero. Inflation has been within the target range since March 2010, but is currently on an upward trend, mainly as a result of food and energy price pressures, with few obvious signs of excess demand pressures. In the event of a significant global downturn, monetary policy will react appropriately.

The policy room available on the fiscal side is more limited, as there is now less fiscal space than was the case at the onset of the crisis. In 2008 South African was running a small budget surplus and the debt/GDP ratio stood at 27 per cent. Since the crisis, government spending levels have been elevated in historical terms, and although the deficit before borrowing has declined from a high of 6,6 per cent in 2009/10 to an estimated 5,3 per cent for the current fiscal year, the debt/GDP ratio has increased to 40,3 per cent, one of the largest percentage increases when compared to other countries over the same period.

A domestic growth slowdown would reduce tax revenues, and there are limits to which the debt/GDP ratio can expand without bringing its sustainability into question. Any further fiscal stimuli would therefore need to ensure a focus on growth-enhancing expenditure.

The weakness in South Africa's traditional trading partners underlines the need to seek new markets for manufactured exports in Asia, and more particularly in Africa. According to the IMF, African economies, with the notable exception of South Africa, displayed remarkable resilience during the crisis. Although most countries experienced lower growth, mainly a result of lower global commodity prices, in general they managed to avoid recession. Unlike South Africa, the trade channel was less important because of the predominance of intraregional trade, and the stronger trade links with Asia. Since then, most sub-Saharan African countries have returned pre-crisis growth rates, in line with those in developing Asia. The IMF estimates growth in SSA to average 5,5 per cent in 2011 and 6 per cent in 2012. In addition to the above, a further reason for these positive outcomes is a recovery in commodity prices as well as improved policy environments

Recent developments in Europe have important lessons for future moves towards economic integration in Africa. Following the European experience in its 40 year move towards monetary integration, it became conventional wisdom that the appropriate sequencing was for full trade integration to precede monetary integration. Africa still has a multiplicity of, and in some instances overlapping regional trade blocs, and has some way to go to full trade integration. At the same time, African monetary integration initiatives are still going ahead in various forums, for example initiatives by SADC and the AU, with different and overlapping timetables, and with inordinate haste in some instances. Unfortunately the thinking behind these initiatives ignores the criteria for optimal currency areas, and focuses primarily on macroeconomic convergence criteria.

An important lesson of the European crisis is that macroeconomic convergence is not enough. It is not sufficient for countries to comply with the initial conditions. It is now clear that necessary conditions include the need for institutions to ensure that these initial conditions are maintained. It is one thing to require countries to achieve certain debt ratios and fiscal deficit ceilings, for example, but are there appropriate mechanisms for ensuring that these guidelines or limits are adhered to?

While the need for harmonised fiscal policies was recognised by the architects of the Eurozone, the issue was dealt with through the Stability and Growth Pact, which has turned out to be a loose, often ignored and unenforceable agreement that countries would abide by certain fiscal guidelines. We have seen the implications of the lack of a centralised fiscal authority, or fiscal counterpart to the ECB. Reaching agreement on, and implementing monetary policy is difficult enough. Fiscal policy is far more complex and political, as it involves policy levers that have more pervasive distributional impacts. It involves for example, decisions relating to tax policies, expenditure policies, and deciding on politically sensitive social and economic priorities. But ignoring the need for such an institution can lead to the difficulties currently being faced by the Eurozone.

That is not to say that regional integration should no longer be a goal in Africa. If anything, the importance of trade diversification has been reinforced by the crisis, and further trade integration in Africa should be pursued more purposefully. But the excessive focus on monetary integration is misplaced and premature. South Africa's trade links to the advanced economies makes it particularly vulnerable to slowdowns in those regions, and more attention should be given to encouraging regional trade and investment flows.

In conclusion, we are living in difficult times. The global economy is on the brink of falling back into what could be a prolonged recession unless purposeful and coordinated action is taken. There are no easy or automatic solutions, but to date policy responses have been incomplete and irresolute. This has led to a loss of confidence and a lack of trust. It is not just the markets that have lost confidence, it is the ordinary people behind the statistics. And as austerity programmes bite further, we are likely to see more scenes similar to those that were recently played out in London and Athens. The challenge for leadership is to rebuild this trust and confidence. It can't be through more talk. There has to be action, but the room for action is limited. Any measures taken are likely to entail significant financial commitments, and these need to be big enough to put a stake in the ground. Such costs should not be looked at in isolation, but in relation to the costs already incurred, and the costs of not resolving the crisis. There is a long, painful path ahead for all of us.

Unless there is a cohesive understanding of who does what, and what is likely to succeed, then we will not rebuild confidence. Not only can it be done, it has to be done.

Thank you.