Lesetja Kganyago: The impact of the Eurozone financial crisis on African Economies

Speech by Mr Lesetja Kganyago, Deputy Governor of the South African Reserve Bank, to the NEPAD (The New Partnership for Africa's Development) Business Foundation, Sandton, 17 April 2012.

*   *   *

Programme Director

Chair of Nedbank, Dr Ruel Khoza

Ladies and Gentlemen

All protocols observed

It is now generally accepted that the global financial crisis showed its first signs in the sub-prime market in USA. It is thus tempting to think that it has got nothing to do with us. However we do know that in a world where the financial systems and the economies are closely integrated, this would have been cold comfort.

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 declined.

What I would like to do today is to address three questions that would hopefully spark a discussion during the panel discussion:

What do we know about the Euro crisis?

What are the channels through which it affects African economies?

How did African economies fare and/or respond during the crisis?

What do we know about the Euro crisis?

Fiscal situation: The fiscal metrics of many Euro area countries have been deteriorating in the past five years. This culminated in the bailing out of Ireland and a Troika programme for Greece, including a very significant write-off. Most Euro area countries have debt to GDP ratios in excess of 60% and this includes even the stronger anchor countries such as Germany and France. In the case of Greece; Ireland; Italy; Portugal and Spain, the fiscal situation also got reflected in higher borrowing costs that made any fiscal stimulus a non-option for policy makers.

Recent budget data suggest that the weaker countries in the euro zone will overshoot their official fiscal consolidation targets. These countries are caught between a rock and a hard place. Save for austerity, fiscal consolidation can only come from faster economic growth.

The growth situation: Growth outcomes have been disappointing in the Euro area, to say the least. Recent data suggest that there could have been further contraction in the first quarter of this year while global growth has not been as supportive to the euro economy. There is also a policy dilemma of balancing fiscal consolidation and providing support to the economy to continue growing. With financial markets reluctant to lend to fiscally weak sovereigns, borrowing costs had risen to the point that it raised the issue of affordability and sustainability. This has left countries to choose a path of austerity to regain credibility. As these austerity measures kick in, developed economies are getting pushed back into recession with implications for the rest of us.

The banking sector and the inter-bank market: The banking sectors in the peripheral countries of the Euro zone carry a large number of potentially bad assets on their balance sheets. Banks had stopped trusting each other leading to a fairly dysfunctional interbank market. There is clearly a clean up to be made. What is not clear is how much of it has taken place.

The ECB had to step in to get the inter-bank market going again with two facilities. Initial indications are that the intervention has worked, at least for now. The markets have reacted positively to this. The Libor-IOS spread in the euro zone, a key indicator of liquidity conditions in the inter-bank market, has declined from its highs in the last quarter of 2011.

The question that faces policy makers is whether the liquidity that has been injected has enabled credit to flow into the real sector of the economy. Initial indications seem to suggest that this is not yet the case. Bank lending to the private sector in the Euro zone barely grew in January and February.

Governments seem to have been big beneficiaries from these liquidity operations. Data from the ECB show that banks' lending to governments grew at 6 per cent in February. It shows acceleration from the 4.6 per cent growth in January. Portuguese banks increased their bank holding of euro area government debt by 4.24 billion euro, Greek banks by 4.12 billion euro while Italian banks increased their holding by 23 billion euro in February. What we observe is that it would take sometime before these liquidity injections start to flow to the real sector.

How did we fare and/or respond to the crisis? How does this affect us as African Economies, what are the channels through which it affects us?

Given the unfolding of the shocks hitting the African economies, 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 rates played a complicating role in how the economy responded to the shocks and to policy.

The impact on African economies so far has been fairly limited. While the economic recovery has temporarily stalled in parts of Europe and growth slowed in North America, the IMF forecasts[1] emerging and developing economies to grow by 5.4 per cent in 2012 – down from 6.2 per cent in 2011 – and by 5.9 per cent in 2013. Sub-Saharan Africa (SSA) is expected to grow by 5.5 per cent in 2012 (compared with 4.9 per cent in 2011) and is projected to grow further by 5.3 per cent in 2013.

Generally speaking, African economies have benefited from stronger commodity prices and greater foreign direct investment. These gains were constrained by currency appreciation in some instances, and more importantly, by rising food prices. So the crisis did feed itself through the commodity channel and the commodities are a double-edged sword for African economies. African economies produce commodities that we export to Europe, China and the rest of the world. There are significant parts of the African continent, including ours, where we are actually importers of crude oil, and as commodity prices rise and the price of crude rises it feeds itself into domestic energy prices and it also feeds itself into domestic food prices. So it is a very important channel to understand. We have been fortunate not just in South Africa, but in many of the African countries, that the effect was actually muted by appreciating domestic currencies as prices of other commodities we export, rose. The patterns of gains across Africa depend on the proportion of commodities in the export basket and the extent to which countries import food and oil. Moderating global food prices should

[1] The data that I used to make the points with respect to the impact of the crisis is drawn extensively from the IMF Regional Economic Outlook published in October 2011.

improve outcomes in most African economies, while sharply lower commodity prices hold some potential for a more serious negative economic shock. This is the double-edged sword of commodity prices that I talked about.

The second channel that the Euro crisis had affected us had been through export growth through-out the Sub-Saharan African economies. When the global crisis set in, export growth from the Sub-Saharan economies declined from an annual average of 7.0 per cent between 2000 and 2007 to only 1.4 per cent between 2008 and 2010. A significant slow-down. Much of this deceleration comes from slower growth in Europe. The proportion of exports from Sub-Saharan Africa to Europe mirrors that of South Africa, where it has fallen from about 36 per cent in 2005 to about 26 per cent in 2011. This trend will continue as sub-Saharan African exports redirect towards faster growing regions of the world. As the IMF points out in the Regional Economic Outlook, between 1990 and 2010, the value of Sub-Saharan Africa's exports expanded at an annual average rate of 8.5 percent. Of that rate, nearly 50 per cent came from growth in exports to emerging and developing economies. The contribution has increased to about 66 per cent between 2005 and 2010.[2]

Exports from Africa to the EU remain strongly biased towards minerals, crude oil and natural gas mainly from Nigeria (and the North African economies of Algeria and Libya) as well as other commodities from countries like South Africa and Botswana. Over the longer term, demand for and exports of commodities will remain strong. China will remain a critical consumer of African exports.[3]

Some forecasts show SSA exports re-achieving growth rates of around 10 per cent later this year. Considerable gains have been made in a number of industries in moving up the export value chains and expanding services exports.[4] Using these gains to diversify export baskets should be an important long-term part of most countries' economic development plans.

The last channel is the FDI one. Foreign direct investment (FDI) flows from the European Union (EU-27) to Sub-Saharan Africa were EUR 11.5 billion in 2010 and this was a decline from EUR 13.1 billion the previous year; and these flows of FDI were mainly to South Africa.[5] To Africa as a whole, FDI inflows reached Euro 21.3 billion in 2010. While this figure constitutes only 5.3 per cent of total EU FDI flows for 2010, the proportion of EU FDI flowing to Africa has increased considerably from 1.3 per cent in 2007. Positive long-term growth prospects in Africa should attract higher levels of FDI in the future. Forthcoming trends will be seen in countries like Brazil, India and China's investments into Africa. As market growth continues and investment opportunities expand, we should expect to see complementary investments by European firms.[6]

---

2 Regional Economic Outlook, October 2011.

3 Regional Economic Outlook, October 2011. China's consumption during 2010 accounted for about 20 percent of world consumption of non-renewable energy resources (oil, gas, coal), 23 percent of major agricultural crops (corn, cotton, rice, soybeans, wheat), and 40 percent of base metals (copper, aluminium).

4 Regional Economic Outlook, October 2011. Kenya and Ethiopia's exports of cut flowers; Rwanda exporting branded coffee and has also broken into the U.S. handicrafts market; Mali (fresh mango exports to Europe), Lesotho (apparel exports), and Uganda (frozen fish). These are also landlocked countries. In Mali, the key innovation was to overcome obstacles by developing a multimodal transport system (road, rail, sea) as an alternative to air freight, while meeting quality and phytosanitary requirements. Service exports have been growing fairly strongly in sub-Saharan African countries, even though not as fast as in emerging partners.

5 Eurostat describes SSA as central and southern Africa, so there could be some discrepancies with other figures.

6 Regional Economic Outlook, October 2011. Chinese FDI to sub-Saharan Africa, as a share of total FDI to the region, climbed from less than 1 percent in 2003 to 16 percent by 2008. Investments from India are also significant: by 2006, Indian investment stocks in sub-Saharan Africa were almost as large as Chinese FDI flows in the region. These investments are increasingly widespread geographically and in terms of industries. Chinese investment is also directed toward manufacturing, construction, finance, agriculture, and service.

SSA economies were in good macroeconomic shape going into the crisis. No wonder we were able to cope better during the crisis. Most countries had balanced budgets or modest surpluses and because of debt relief initiatives, debt levels were also low. Countries had accumulated reserves and modest savings levels and inflation was relatively low or under control. Thus, most countries had flexibility to ease policies, which helped to dampen the impact of the crisis particularly on poverty alleviating initiatives. However, countries that did not have flexibility of easing macroeconomic policies continued to rely heavily on foreign aid.

Policy adjustments in most of the African countries have been country-specific. It should be pointed out that Africa is not a homogeneous geographic space, it is a continent made up of countries, so the policy responses were also country-specific. In response to price shocks, few flexible exchange rate countries have had to tighten monetary policy. However, interest rates remain at low levels set during the financial crisis. Nominal effective exchange rates have weakened in some countries and some oil-exporting countries have increased reserves sharply.[7] Fiscal policy has loosened in many countries, including ours, to support growth and to finance more expansive capital investment projects. Weak control over public finances remains an issue in some countries, and needs to be countered by more aggressive institutional development, governance reforms, and human capital building.

Now let me share with you some perspectives about Africa's largest economy. Most of the comments that I would be making on SA flow mainly from a speech I delivered on the 17th March 2012 somewhere in Magaliesburg.

South Africa's policy discourse during the crisis centred 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; that is 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 of the currency would have required macroeconomic policy tightening to rein in domestic expenditure and moderate inflation. In practice this meant either that the domestic 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 short-term interest rates, the other options entailed reducing public spending on current programmes or tax increases. Exactly what you do not want to do when you are in a crisis, because you want to act counter-cyclically. Taking that stance would have meant that you act pro-cyclically and you would have plunged the economy into recession.

The approach taken by the fiscal authorities 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.

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.

7 Nigeria being an exception. Reserves have fallen and the exchange rate has depreciated.

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.

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 the demand for exports from around the world.

The ***third disorder*** that we need to be alive to is a possibility for financial contagion that will affect emerging market economies. In this instance, countries with financial and/or economic vulnerabilities would experience local currency asset sales, capital flight, and long term negative effects in 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 they provide 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 globally 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 both monetary and fiscal authorities.

We have been lucky in South Africa because our fiscal and monetary authorities responded in sync. What we are not saying as South Africans or we are not saying it as strongly as we are supposed to, is that South Africa entered the financial crisis with a very resilient, robust and well capitalised financial system.

The South African banking system is rated amongst the best in the world. It is rated just behind that of Canada by the World Economic Forum. It is a very strong financial system and is rated ahead of the financial system of the USA. It has become a national strength while elsewhere the financial sectors have become a key weakness and that actually matters.

As this crisis continues, there is one distinguishing factor about the South African financial system, besides the fact that the South African financial system continues to function, the South African interbank market also continue to function. Banks in South Africa continue to trust each other and had been lending money to each other, thus facilitating the flow of credit for the real sector. Whilst credit in Europe is only growing at only 1 per cent, credit in South Africa is growing at close to 8 per cent, which means that indeed credit is flowing.

But there is something else that is supposed to be highlighted. It is the fact that not only is the South African financial sector well capitalised, our big corporates actually have very strong balance sheets and borrow from the capital markets .They have no reason to be borrowing money from the banks save for working capital .Credit in SA used to grow at double digits. It now actually grows at 6 to 8 per cent, while we have inflation at 6 per cent. It is actually a fairly decent growth rate. As such from a regulatory perspective, it suggests that you do not have a credit fuelled bubble actually building up.

As we look at our financial sector let us also not forget that even with the global regulatory standards coming into being, South African Banks already comply with most of the new standards, even before they come into effect. That is how strong our financial sector is.

A lot has been said about the growth of unsecured lending in South Africa. Of course, as regulators we are concerned about the growth in unsecured lending, but South Africans, do we really know what we want. Two years ago we said to the banks, you only want to lend money to people who have security. So the banks have come around and said well it looks like South Africans want us to lend to people who don't have security, unsecured. Then we turn around and we say that well there is problem here, you are lending money to people who are unsecured, so I'm not sure what we are actually looking for.

Nonetheless from where I am sitting as a regulator, everything that is growing too fast is a reason for me to worry about. If the share prices rise too fast, I get worried. If property prices rise too fast, I get worried, if credit rises too fast, I get worried and if unsecured credit rises too fast, I get worried. That is why the National Credit Regulator decided they want to go and dig and understand what is driving this unsecured lending. That is why from the South African Reserve Bank we asked the Registrar of Banks to go around and understand what is driving this unsecured lending. It is growing and it is growing too fast, but this is from a low base.

But let us also say something here, the banking sector is a three trillion rand industry, and unsecured lending has grown from 23 billion to some 50 billion rand; it has doubled and is growing too fast. But it is such a small component of the sector. I don't know how many of you use this unsecured lending; I do use it, but I only use it through my credit card. The categories that have me worried are not the credit card lending or overdraft facilities, but it is actually more the personal loans and we would want to get to understand what is actually driving this. This said, even if this entire R50bn falls into default it won't make a dent on the banking sector.

To conclude, African economies need to strengthen the domestic and regional basis for growth. This is best done by strengthening regional and extra-regional commercial and trade agreements, developing cross-border infrastructure, strengthening macroeconomic policies, and developing institutions and human capital. Attracting foreign direct investment and making better and more use of imported technology and skills is also critical to long-term growth. These efforts are not made easier by the difficulties of the world economy, which have generated volatile capital inflows and depressed trade. The former complicates macroeconomic management somewhat. The latter reduces growth in exporting industries and increases competition for domestic firms.

African economies entered the crisis with a very strong footing thanks to very prudent macroeconomic policies. Africa will continue to grow even as Europe slows down, but we better be alive to the fact that Europe is a very important trading partner for us. It is an important destination for our exports and it is a very important source of FDI and if you are from the lower income African countries, it is also a very important source of technical assistance and foreign aid.

And with those words I would like to say thank you very much for your attention.