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South Africa and the global economic crisis[1]

Stephan Malherbe

THE WORLD is in economic turmoil to a degree not seen in 60 years. Consider some of the indicators:

- The global economy will shrink this year – the first time this has happened since World War Two.
- In the fourth quarter of 2008, global industrial production fell by more than a fifth year-on-year.
- Global trade plummeted in a way normally associated with a sea lane disruption or a major war. Most major countries' exports have fallen by 25 per cent or more.
- As at March 2009, more than $50 trillion was wiped off the notional value of global investment holdings.[2]
- Between July and December 2008, non-energy commodity prices fell by more than a third, and oil prices by two-thirds.

A country distracted

These facts alone should give pause to the relative equanimity with which South Africans, and South African policy-makers in particular, have been viewing the crisis. Senior economic policy-makers have long been trained to present a calm and unruffled public face, and much of what is presented to the public should be seen in that light. What matters is not the public face, but the contingency planning taking place behind the scenes. The crisis is occurring at the end of a long economic upturn in South Africa, and at a time when the energies of the ruling party and senior politicians have been turned inwards,

notably towards major factional battles inside the ANC, the legal battles around the president, and the general election. NEDLAC has produced a joint position on the crisis which, while pleasing in its consensus, is disappointing in its lack of engagement with how the crisis may unfold, and the key choices facing the country. This position is likely to be overtaken by events.

The principal fact is that, even as the first phase of the crisis draws to a close in global financial centres, South Africa remains vulnerable. The immediate source of our vulnerability is our unprecedented short-term reliance on international capital inflows at a time when capital has dried up globally. We need to prepare for a reversal. An old pattern of the South African economy may be reasserting itself after being in abeyance for more than two decades – only in far more treacherous global circumstances. That pattern is one of 'growth at last, halted' – where a period of South African growth, sponsored by foreign capital, is brought to an abrupt end when inflows cease. It is worth also considering what the *ultimate* causes of that recurring dynamic might be.

South Africa's new administration, fresh from a resounding election victory, needs to prudently manage the country's way through the crisis, and five specific recommendations are made below in this respect. But President Zuma and the coalition of interests that his government represents also need to apply their minds to preparing the country to prosper in the global economy we shall find once the dust of the crisis has settled. Amongst the clamour of voices proposing specific programmes, some reflection is required on the basic structure and functioning of our economy, and how to address the structural weaknesses of our economy laid bare by the crisis.

South Africa's new administration needs to prudently manage the country's way through the crisis

An epoch-unmaking event

Three aspects of the crisis explain why it will shape the next decade economically – in South Africa, and the world.

First, the crisis has cracked the entire structure of international economic relations that drove the last decade's growth. That was the interaction between producing, saving Asia, and consuming, borrowing United States. Out of the wreckage of this dynamic will emerge a new pattern of global economic activity and influence. We cannot predict what that will look like, as the political forces unleashed within the two principal protagonists still have to be played out. What can be done is to consider different futures, and Africa's and South Africa's prospects.

Second, the crisis has eviscerated the two drivers of South Africa's growth over the last decade: ever-increasing availability of credit, and sharply higher commodity prices. What it has not hurt – yet – is South Africa's economic stability. Even in the best of outcomes, the growth and employment prospects for South Africa for the next few years will need to be recalibrated. At worst, we face a slowdown that lasts several years.

Third, the ideological consequences of the crisis will, in the fullness of time, be substantially greater than the direct economic consequences. There is a reservoir of anger at the American ground zero of the crisis; there is a powerful current of anger in South Africa's body politic. Before this is over there will be anger, and disillusionment, in China, in Venezuela, in parts of the Middle East and in Eastern Europe. As a force for political change, anger trumps hope. How political leaders around the world channel post-crisis anger may determine country winners and losers in the long run.

From where we came: a golden era of low-inflation growth

Consider our economy over the past decade. In the 1990s, South Africa, guided by Trevor Manuel, made a large and costly investment in economic stability: The fiscus was stabilised, public sector dissaving eliminated, and inflation brought down. Real interest rates fell to historically low levels, and the stage was set for an expansion of credit and economic activity. Between 2000 and 2007/2008 the economy grew by almost 40 per cent[3], one million additional jobs were created[4], and government revenues increased by 153 per cent with 'social wage' spending being amongst the main beneficiaries. South Africa could boast one of the most extensive social welfare programmes in the developing world.

The crisis has eviscerated the two drivers of South Africa's growth over the last decade

Lionised by business, distrusted by unions, Manuel kept his own counsel. He was accused of being subservient to the orthodoxies of the time, and of the kind of technocratic betrayal of liberation to which ministers of finance seem particularly prone. History will judge him differently. In fact, he deployed economic orthodoxy to effect a historic expansion of state transfers and services to the poor, and presided over a tremendous surge in household consumption at all levels. He attempted something of surpassing importance: a reconciliation between the imperatives of a still divided and unequal South Africa, and the imperatives of running a modern economy. Whether this grand reconciliation survives the crisis – and indeed the transfer of power to a new administration – time will tell.

The strategy of prudence and credit growth greatly exceeded the expectations of even its architects. This too was good news, testimony to the underlying vitality of South Africa's economy. Had we looked at the rest of the world, though, we would have noticed something odd: an astonishingly large number of countries were pulling off a similar economic resurgence *at the same time*. From Africa to Argentina, countries were achieving high growth, accompanied by low interest rates and burgeoning consumption, with inflation firmly, miraculously, in check. By 2007, all the countries in the world bar a few misfits (notably Venezuela, Zimbabwe and Iran) had achieved single-digit inflation – possibly the first time since the invention of fiat money in the 1930s that this had been the case.[5]

The spread of Manuel-like policies around the world had something to do with it. But the sheer scale of growth and the subdued pricing response suggested something else was afoot. That was one of the most powerful trends of our time: the post-communism entry of an additional approximately one billion workers into the world economy. Between 1989 and 2008, the number of workers in the export sectors increased from 300 million to 800 million. These workers were also part of a productivity revolution: by leaving the rice paddy for the factory, a Chinese peasant tripled her output – a journey made by 120 million Chinese peasants in the last ten years. As far as manufactured goods go, the world was awash in plenty, at low prices.

In this global drama, South Africa was more like the United States or Spain than China or Vietnam

At the same time, these workers' savings financed the very consumers across the world buying their products. Over a two-decade period, the Chinese working class indirectly lent more than $1 trillion in savings to the American middle class (some of it by way of US Treasury bonds). The vast increase in global savings kept real interest rates at low levels and allowed the upturn to continue for an exceptionally long time. It is this dynamic of massive Chinese production and savings, matched by massive American consumption and borrowing, that drove global growth during the Manuel era. The very length of the boom allowed for excesses in credit markets to grow and ultimately reveal themselves in a way that shook assumptions to the core.

In this global drama, South Africa was more like the United States or Spain than China or Vietnam. Since 1995, South Africa has accumulated R545 billion[6] from foreign savers. These inflows enabled us to maintain our consumption and investment far above our actual production.[7] The provision of foreign credit was mirrored by a massive increase in *domestic* credit (by 174 per cent between 2000 and 2007)[8].

South Africa also benefited from the extraordinary run-up in commodity prices brought about by the US-China growth engine. As at 2007, China accounted for 25 per cent of world consumption of metal commodities and 8 per cent of world oil consumption[9]. Non-energy commodity prices increased by more than 80 per cent[10] between 2002 and 2006, and South Africa's value added generated from commodities during that period increased by more than R90 billion. Not all of this was beneficial; crude oil and food prices increased markedly, but the overall impact on South Africa was positive. Following the crisis, prices have reverted sharply towards long-term trend values.

Where we may be headed: the crisis and capital flows

When a financial system works well, there are funds available for sound investments; during a boom, the financial system increases the level of available funding, often into what will ultimately prove unsound investments. When the financial system finally loses confidence in its ability to distinguish between sound and unsound investments, no-one wants to lend to anyone else (least of all to other financial firms) – and you have a financial crisis. Translate 'funds available' into the term 'liquidity', and one can see that a crisis is precipitated by excess liquidity, and results in a sharp drop in liquidity.

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Consider how the developing world has been and will continue to be affected by the life cycle of this financial crisis. In 2006, private capital of $565 billion flowed to the developing world[11]. In 2007, in retrospect the height of the liquidity boom, the number increased to $929 billion. These inflows meant strong currencies, low prices, and low interest rates – and more consumption and investment. In 2008 as financial entities stopped lending and funds became scarce, the number fell to $466 billion. This year an inflow of only $165 billion is predicted, a fall of 71 per cent from the 'normal' levels of 2006.

The various forms of foreign funding of developing countries tend to be affected by the crisis somewhat differently. As can be expected in a crisis where banks have fundamentally stopped lending even to one another, bank lending to developing countries has largely stopped, and some $61 billion on a net basis is expected to be repaid. Equity flows (negative for a while), are expected to be zero on a net basis. Globally, foreign direct investment is expected to be the only source of significant inflows to developing countries (expected at $197 billion), and there is a glimmer of positive news in the remaining category, bond flows, an expected $31 billion.

According to the World Bank, this year the developing world will have a 'gap' between inflows and outflows requiring financing of $270-700 billion. Compare that to the inflow from private sources of $165 billion and flows from official sources of $29 billion. The implication is that the developing world as a whole probably still needs to take a large step down in its level of spending. The Bank points out that during 1981-'86, net private inflows to the developing world fell by 3 per cent of GDP; during the emerging markets crisis and its aftermath, net private inflows fell by almost 4 per cent of GDP. This time, it is expected that private capital inflows to the developing world will fall by almost 6 per cent of GDP within the next 24 months; domestic expenditure will have to fall commensurately.

And South Africa . . .

South Africa is not exempt from these events. How might we be affected? Firstly, note that during the last year net capital inflows – effectively all of which came from private sources[12] – came to 7.4 per cent of South Africa's GDP[13]. Historically speaking, this is an extraordinarily high proportion: a decade ago, such a deficit, called the current account deficit, would have been considered unsustainably high at 4 per cent of GDP. And the 2008 current account deficit was preceded by a period of 5 years of high deficits totaling R376 billion.

South Africa clearly needs to position itself as a superior credit amongst developing countries if it wishes to soften the blow of the crisis

If our current account deficit is to remain at the 2008 level this year, we shall require $16.7 billion in net inflow to finance it[14]. In other words, we would need to attract approximately 10 per cent of all private capital expected to go to the developing world – in 2006 and 2007 we attracted 2.8 per cent and 2.2 per cent respectively.[15] South Africa clearly needs to position itself as a superior credit amongst developing countries if it wishes to soften the blow of the crisis.[16]

If full funding is not forthcoming, the economy and the currency will need to adjust very quickly to straitened circumstances. Assuming exports are fairly fixed over the short term, first principles suggest that the rand will have to fall sufficiently to have imports fall to close the gap. To achieve this either domestic investment or household consumption, or both, will need to contract sharply. In reality, the rand is likely initially to overshoot, taking us into a rocky if brief period in which capital flows and subjective valuations of the rand will drive events. How we conduct ourselves during that period may turn out to be critical.

The composition of South Africa's capital flows offers some clues as to the size of contraction that awaits us. We are lucky not to have placed reliance on the notoriously volatile bank-to-bank flows (in which a withdrawal not only decimates the currency, but places often intolerable strain on the domestic banking system). Less helpful is South Africa's lack of foreign direct investment – usually the most solid flow, and unlikely to actually reverse. In fact, some 77 per cent[17] of our inflows over the last five years have been in the form of portfolio flows, i.e., flows into our bond and share markets. Portfolio flows are less volatile than bank flows. This is due to one useful attribute: as outflows start, the selling prices of these assets *fall*, discouraging foreign holders to sell and expatriate their funds. At a time of undifferentiated criticism of financial markets, it is worth remembering that our well-developed equity and debt capital markets have served us well by offering a relatively safe entry point for all that foreign capital into our markets.

Whilst our capital markets helpfully tend to dampen outflows just when these threaten, sharp reductions in new inflows may at some point be unavoidable. Such reductions often follow a period of high *in*flows, which – given our national aversion to saving – tend to coincide with the period when, at long last, investment is finally sizable enough to promise sustained growth in employment and output. Optimism blooms, and then the axe falls. Since 1970, South Africa has had four episodes of large and sudden falls in capital inflows: 1972, 1977, 1982 and 1985. In the first three cases, after unusually strong inflows, net capital inflows fell by an average of 5.5 per cent of GDP on a year on year basis, ushering in a sharp but brief recession. We shall return to the fateful year of 1985 below, because it casts an interesting light on current events.

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On the face of it, this start-stop pattern of growth was abolished during the Manuel years: between September 1999 and September 2008[18], the economy had its longest sustained expansion since the Second World War. But it is now less clear that the structure of the economy has really changed. The 1999-2008 interval may have reflected, first, a period of catch-up as foreign investors rebuilt their South African positions, followed by participation in the golden era of international liquidity described above. The recent period of growth again went hand in hand with large current account deficits. We have continued to save far less than our counterparts in the developing world – too little to reliably fund the investment required for the growth in employment we need.

Blip, or continuing drain?

That leaves us with an urgent short-term question: we have to climb down from the deepest current account deficits in forty years at a time when global funders' ability and inclination to finance a gentle and gradual descent remains in some doubt. There have been some signs over the past weeks of a resumption of portfolio flows into emerging markets as our economy has slowed. If those trends continue, a smaller adjustment will be needed. But one way or another, our expenditure needs to fit the willingness of foreigners to fund it.

How we manage this adjustment, and the next twelve months, has long-term implications. Let's return for a moment to the fourth episode of a rapid reversal of capital flows, 1985. Unlike its predecessors, the episode was sharp, but not short. Instead it ushered in a five-year period of sustained outflows, occasioned by the imposition of financial sanctions. The economy buckled, the National Party government lost confidence, and apartheid was done for. And for the *subsequent* five-year period net inflows remained so muted that the economy stood still.

Given South Africa's lack of domestic savings, no inflows over a sustained period mean little or no growth

What we learn from the early 1990s is that, given South Africa's lack of domestic savings, no inflows over a sustained period mean little or no growth – even with high budget deficits. Returning to the present, then, the real question is whether the withdrawal of foreign inflows is temporary or whether it will persist. In a worst case scenario of persisting low inflows, output and employment may fall and remain low for a prolonged period, with inflation and high nominal interest rates eroding the incomes and savings of working people.

South Africa's reliance on foreign rather than domestic savings creates its own imperatives. As pointed out before, the critical inflows for South Africa are into rand denominated debt securities and equities. Continued foreign investment in our bonds will requires low and stable inflation and fiscal deficits. Continued foreign investment in equities will require stable economic policies that create space for private commercial success. Therefore, in these difficult times and beyond, perceptions of long-run fiscal, monetary and other economic policies must be stable. Absent that, holders of our financial assets may decide to continue exiting the country even as asset prices continue to fall. In today's world there is no room for error with respect to core economic policies.

It should be noted that continued capital inflows into South Africa are as critical for the left as for the right or the centre. Consider a left-leaning policy programme of expanding government expenditure to assist the poor, invest

in infrastructure and increase economic activity through state spending. That strategy is only feasible, affordable and effective if foreign inflows match the expansion of debt. Absent that, it neuters itself by displacing activity elsewhere in the economy.

More generally, attracting international flows to developing countries will not become easier. At a time when borrower prospects look bleak, lenders' own problems are resulting in diminished funds. In the longer term, US crisis-related funding means that the US government (excluding roll-overs) will require capital market funding of close to $10 trillion over the next 10 years. This may massively crowd out attempts by developing country governments and firms to borrow.

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Five-part insurance policy against a SA-specific crisis

There are signs that the Northern countries' emergency measures to salvage the US and European banking sectors are gaining credibility. At the same time, blue-chip borrowers are re-entering global credit markets. Resources prices are off their lows and some funds have flowed into equity markets. With some luck, the depths of the US-centred *financial* crisis have been plumbed. Now the sharp contraction in the *real economy* has to play itself out. The world will also need to adjust to a slower-growing Asia and a US government deficit massively crowding out private investment. We may be at a moment reminiscent of the mid-point of the 1997/98 emerging markets crisis, when countries like Russia and South Africa, having survived the initial crisis intact, were struck by considerable, unexpected aftershocks. South Africa faces this complex environment at a moment of political transition. Steady leadership is called for. In particular, the following needs to be done to minimize the chances of a large and sudden reversal of capital flows to the country:

First, President Zuma and his quartet of ministers tasked with the economy need to explicitly recognize the short-term economic challenges facing the country following the global crisis, and explain how these will be managed.

Second, the new leadership needs to strongly and unambiguously endorse the three core tenets of our current economic policy: an independent Reserve Bank and disciplined application of inflation targeting; stable fiscal policy with low long-term budget deficits and hence low real long-term interest rates; and an increasingly competitive market economy. The new administration can *add* to this list, but it cannot *subtract*. Of the items on the list, inflation targeting is most in the firing line. At this point, abolition or perceived weakening would

be reckless. But improvements are possible, even necessary, following what we have learnt in the last five years and the crisis.

Third, good policy words are only credible if followed up with sound and consistent choices for key positions. Four posts – minister of finance, director general of National Treasury, governor of the South African Reserve Bank and head of the SA Revenue Service – need to be filled in a way that mirrors the policy message of continuity, stability and competence. Whilst not all these posts are necessarily settled, the economics appointments thus far have signaled the right mixture of continuity and change. Coordination between so many centres of power will be a challenge, and one expects that if South Africa were to be caught in crisis aftershocks, minute-by-minute stewardship of the economy would need to be performed by a small, cohesive group.

Fourth, South Africa needs to take out insurance in the form of a large and unconditional borrowing facility with the International Monetary Fund. Mexico has led the way in this respect with a facility in excess of $30 billion announced in March, on top of a significant currency swap facility with the US Federal Reserve. In recent months and years South Africa has been a co-architect of the multilateral financial architecture, not least through a prominent role in the G-20 group of developed and developing nations. The time has come to use that architecture in the smartest way: as prevention rather than cure.

Good policy words are only credible if followed up with sound and consistent choices for key positions

Fifth, the country should have a clear view as to what should – and should not – be cut if expenditure is to be reduced. We remain a country with a large number of citizens outside the formal economy: investing for long-term growth to complement spending on social protection remains a priority.

Beyond the urgent lies the important

Adjusting our view of the world. Great events can result in ideological shifts, and that is a likely result of a crisis of this magnitude. The popular view, that financial engineering made a few people very rich and now is impoverishing the world, has much to commend it. But what conclusions do we draw from it? Certainly, banks wishing to run proprietary trading books should be required to hold large amounts of capital given the negative externalities when things go wrong. Further, there is a debate to be had about which forms of lending are inherently risky if left to expand. These are all questions about the match and the flame. The fuel of this crisis was the profound imbalance between Asian

saving and Western (and to some extent South African!) consumption. How to limit the risk of such imbalances building up is an important question.

Post-crisis ideologizing, fun as it may be, can go too far. There will always be a need to bring together funders and those in need of funds, i.e., a need for financial intermediation. And some of that intermediation – as our own experience shows – is best done through capital markets. So the rethink should be about what the best financial system should look like, not about whether we should have capital markets and risk-based securities.

Is this crisis a repudiation of early 21st century capitalism? It certainly bloodies the noses of those who suggested that complex financial markets do not require much regulation. But the crisis experience has nothing to say about the main precepts by which modern market economies are run: the value of free trade, the need for competitiveness and export orientation, the value of competition between firms, the experience that businesses are generally better run privately than by the state, the social usefulness of property rights, the importance of human capital, and the moral imperative of societies to help poorer citizens build up their human capital, and live lives of dignity. These still stand – although that does not make them immune from questioning and debate.

The global economy will not be in a brace position forever. At some point, trade and financial flows will normalise

Preparing for the world that follows. The global economy will not be in a brace position forever. At some point trade and financial flows will normalise. When that happens, the world will not look the same as it did a year ago. Some of the shifts can be anticipated: a world with less money for investment, higher risk premiums and more inflation – in other words, a less forgiving world. Further, US financial pre-eminence is likely to be eclipsed (not least due to the regulatory backlash in the US). Under certain scenarios, the global role of the dollar may change – an important issue for a gold and commodities producer such as South Africa. Asia, the driver of global productivity, will also look different. It is worth giving some thought to these changes, and what they might mean for South Africa.

Structural reform. Like those countries at the epicentre of the crisis, we have to ask ourselves some uncomfortable questions. Two spring to mind. The first is about savings. South Africans' habits of credit and consumption lie behind our dependence on foreign flows: is this how our economy should work, or will we be forever vulnerable? The second question is related: in an otherwise bravura performance of macroeconomic prudence over more than a decade,

our government allowed our external position and our currency to be outcomes, rather than areas of direct focus. Did this allow too much risk to build up? Should a developing country pay more attention to its financial interaction with the rest of the world? The answers to these questions may change the way in which we govern ourselves.

Stephan Malherbe is chief executive officer of Genesis Analytics.

Endnotes

1 Diligent research assistance by Yaseen Jhaveri is gratefully acknowledged.
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12. South African Reserve Bank, Time Series Data. Own calculations.
13. South African Reserve Bank, 2009. Time series Data in The Quarterly Bulletin (2009). Own calculations.
14. Calculated using Morgan Stanley's forecast of a 1 per cent decline in South African GDP in 2009.
15. Institute of International Finance, Capital Flows to Emerging Market Economies. Own calculations.
16. Were our current account deficit to extend to 10 per cent of GDP as suggested by some, we would require 15 per cent of all private capital destined for the developing world ($24,8 billion) to finance it. Even if the current account deficit were to decrease to 5,5 per cent of GDP, we would still need to attract 7,5 per cent of private capital ($12,4 billion).
17. South African Reserve Bank, Time Series Data. In nominal terms.
18. Ibid.

The Centre for Development and Enterprise
Transmedit Place, 5 Eton Road, Parktown
Johannesburg, South Africa
P O Box 1936, Johannesburg 2000
Tel 27 11 482 5140
Fax 27 11 482 5089
info@cde.org.za
www.cde.org.za

Business Leadership South Africa
St Margaret's, 3 Rockridge Road, Parktown
Johannesburg, South Africa
P O Box 7006, Johannesburg 2000
Tel 27 11 356 4650
Fax 27 11 726 4705
info@businessleadership.org.za
www.businessleadership.org.za

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