South Africa’s Policy May Offset the Financial Downturn

BY BRIAN KAHN

As the global crisis unfolded during 2008, it initially appeared as if South Africa, along with other emerging market economies, would be relatively unaffected. South Africa’s banking system was only marginally exposed to the subprime assets that initiated the crisis, and commodity prices accelerated during the first half of the year. The U.S. dollar prices of South Africa’s commodity exports increased by some 26 percent between December 2007 and June 2008, while the domestic equities market reached an historic high in late May of that year. Initially the most significant direct impact of the global financial markets crisis on domestic markets was a 36 percent decline of the financial sector index on the domestic equities market between November 2007 and July 2008. The decoupling hypothesis—that emerging markets in general were no longer intricately tied to the fortunes of the advanced economies—appeared to have some validity.

During 2008 the domestic economy was beginning to show signs of moderating, after 5 years of growth of some 5 percent or more. Consensus forecasts at the time indicated that growth was expected to average around 3.5 percent in 2008 and 2009, before returning to rates of around 5 percent in 2010. This slow-down was due in part to emerging electricity supply constraints and a tightening of South Africa’s monetary policy stance. The repo rate had been increased by 500 basis points between July 2006 and June 2008 in response to a higher inflation trend induced by sustained above-potential growth, real...
household consumption expenditure growth of around 9 percent in 2006, and higher oil and food prices. The higher expenditure brought about a widening of the deficit on the current account of the balance of payments which had reached a level in excess in 7 percent of GDP in 2007 and 2008. These deficits were financed primarily through portfolio capital inflows. A prudent and conservative fiscal policy was also being implemented, and in the 2006 budget, modest surpluses were budgeted for the next three fiscal years. The public sector borrowing requirement was projected to increase from a small surplus to a deficit of 1.4 percent of GDP in 2010/11.

The situation and outlook changed dramatically after September 2008 in the wake of the demise of Lehman Brothers. The collapse of global confidence led to a flight of capital from emerging markets, a dramatic decline in commodity prices, and plummeting demand for exports from emerging markets. South Africa was not spared. Its relatively diversified export market and product base were insufficient to shield the economy from the fall-out of this synchronized global downturn.

The effect was quickly felt in the financial markets. From its peak in May 2008, the domestic equities markets lost 36 percent in value by the end of the year, and 22 percent from mid-September. The commodity price index of South Africa’s exports declined by over 30 percent by October compared with its June levels, although the terms-of-trade blow was cushioned to some extent by the fall in international oil prices and the resilient gold price. Portfolio capital flows turned sharply negative in the fourth quarter of 2008, although the overall financial account remained positive, partly as a result of repatriation of foreign currency balances held abroad by domestic banks. Not surprisingly, these developments had an impact on the rand exchange rate which became highly volatile and depreciated from a level of around R8.00 against the U.S. dollar in September 2008 to a low of around R11.80 in November. However by December it had settled down at a level of around R10 to the U.S. dollar. Because of the limited exposure of the economy to foreign debt, balance sheet effects of these currency movements were relatively limited.

These developments were reflected in the sudden and sharp downturn in the domestic real economy. Having grown at quarter-on-quarter seasonally adjusted and annualized rates of 5.0 percent and 0.2 percent in the second and third quarters of 2008 respectively, the economy contracted by 1.8 percent in the fourth quarter of that year, and by 6.4 percent in the first quarter of 2009. The mining and manufacturing sectors of the economy were particularly hard hit: the manufacturing sector recorded negative annualized growth of 22 percent in both the fourth quarter of 2008 and the first quarter of 2009, while the mining sector recorded growth rates of 0.4 percent and -33 percent in these quarters. In the second quarter of 2009 the economy contracted at a rate of 3 per cent, with the manufacturing sector recording a contraction of 11 per cent. The mining sector experienced a turnaround, with a growth rate of 5.5 per cent. Nevertheless the South African economy appears to be lagging behind the recovery in a number of the advanced economies. The effects on employment were felt in the first quarter of 2009 when 179,000 jobs were lost in the formal nonagricultural sector. Exports of both manufactured goods and primary commodities declined sharply. In the first quarter of 2009, total export values had declined by 21 percent compared to the previous quarter.

Fortunately, effective regulation and bank supervision shielded South African banks from direct exposure to the troubled securitized debt market in the U.S., and they remained well capitalized. Furthermore, South African banks are predominantly funded by domestic deposits and not through foreign-held structured products. Consequently, unlike many other central banks, the South African Reserve Bank did not at any time have to respond by injecting additional liquidity into the domestic money market. The domestic interbank market continued to operate smoothly with no anomalies observed in either the volumes or rates of interbank funding.

However, some deterioration in asset quality was observed in the course of 2008, which was probably attributable to the monetary policy tightening of the previous period. But impairments increased significantly as the economy contracted. Although there is adequate provision for impaired loans, banks have reacted to the downturn in a pro-cyclical manner by significantly tightening credit criteria to both households and the corporate sector, thereby exacerbating the downturn. Credit markets have therefore been affected by a reduction in both the supply of and demand for credit. Credit extension to the private sector, which was growing at rates of around 28 percent in January 2008, had declined to rates of around 4 percent in June 2009. Overall this represents a decline in real credit extension, although a number of components of credit extension became negative in nominal terms as well.

The official policy response was to allow for greater flexibility in the application of monetary and fiscal policies. In December 2008, the Monetary Policy Committee (MPC) of the South African Reserve Bank reduced the repurchase rate by 50 basis points to 11.5 percent. In February the frequency of MPC meetings was increased to monthly, to allow for a more continuous assessment of the rapidly changing situation. The repo rate was reduced further by 100 basis points at the February meeting and at each of the subsequent three meetings. The monetary policy stance was unchanged at the June meeting, but at the August meeting the repo rate was reduced by a further 50 basis points, bringing the total reduction to 500 basis points.

These actions were taken even though inflation, which measured 10.3 percent in December 2008, was well above the target range of 3–6 percent. However, the forecasts were for inflation to decline markedly over the next few months, and to return to within the target range by 2010. By July 2009, the inflation rate had declined to 6.9 percent. The MPC maintained a focus on inflation in a forward-looking flexible inflation-targeting framework: although inflation was outside the target the committee was satisfied that it would return to within the target range over a reasonable time horizon. In addition, the widening output gap was seen to impart a high degree of downside risk to the inflation outlook.

Nevertheless there were a number of upside risks to the inflation outlook that constrained the monetary policy
response. Some of the emerging upside risks included high nominal and real wage demands and settlements, a turnaround in the international oil price, stubbornly high food price inflation despite a significant decline in agricultural commodity prices, and high rates of increases in administered prices. These factors also contributed to deteriorating inflation expectations.

The monetary policy stimulus was complemented by a countercyclical fiscal policy. South Africa was in the fortunate position of having sufficient fiscal space—a result of past prudence—to use fiscal policy in a manner that would not raise questions about sustainability. It is generally agreed that fiscal stimuli in such circumstances should be reversible, with an emphasis on increasing growth-enhancing capital expenditure. The problem is that capital expenditure takes time to implement and so may not be well-suited for cyclical purposes. It was therefore fortuitous that government had embarked on a large-scale infrastructure expenditure program during the earlier part of the decade (including road and rail infrastructure, telecommunications, and more recently electricity generation), and much of this was coming to fruition at a time when most need was from a cyclical perspective. Government and state-owned enterprise expenditure on infrastructure is expected to average 9.7 percent of GDP over the next three years compared with 4.5 percent of GDP in 2005/06. The public sector borrowing requirement is now expected to increase to 7.5 percent of GDP in 2009/10 before moderating to 5.3 percent by 2011/12. These demands on the capital markets are sustainable because government debt to GDP is currently a modest 22 percent.

There was also direct stimulus through the budget. The government had budgeted for a surplus of 0.6 percent for the 2008/09 fiscal year, and with declining tax receipts the outcome was a deficit of 1.2 percent. As a result of the slowing economy and a discretionary fiscal stimulus, a deficit of 3.9 percent of GDP was budgeted for the 2009/10 fiscal year. It is estimated that about half of this increase was due to lower expected tax receipts, implying an expenditure stimulus of some 2 percent of GDP. More recently the minister of finance noted that tax revenues are likely to be somewhat lower than anticipated, and a higher deficit outcome is likely. However the government has projected deficits for the next two financial years to decline to 3.1 and 2.3 percent of GDP respectively.

South Africa has not been spared from the impact of the global crisis. However its policy response should to some extent help to contain the contraction. Some internal and external developments indicate that the worst may be over. Portfolio capital inflows have resumed; the rand has appreciated to almost pre-crisis levels; commodity prices have recovered from their lows, although still significantly below their highs of last year; and most leading indicators show that positive growth should be achieved during the latter part of this year. Nevertheless the recovery is likely to be slow and hesitant, and dependent to a significant degree on the nature and speed of the global recovery.

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level of integration and interconnectedness of the financial system in the EU and in the transition countries would make such a crisis even more devastating than the current one. This is why the International Monetary Fund (IMF) has been called back to support global financial stability—to bail out the banks in effect. It can be expected that many countries in transition will end up with stand-by agreement before this crisis is over. In addition, the IMF is supporting the so-called Vienna Initiative, which is a commitment by the banks in countries that have an IMF program to keep their credit exposure at existing levels, which should help the process of orderly deleveraging. However, in the event of mishaps, financial failure would be transmitted through the interconnected banking system quite quickly (Arvai, Driessen, and Otker-Robe 2009).

The other risk is that these economics may experience stagnation in the medium run. That will have serious consequences for labor markets. Employment will decline anyway and slow growth will accentuate the already existing structural imbalances in these markets (high unemployment, significant segmentation, low employment), possibly leading to social problems and to growing populism. There is little that the EU can do to address that eventuality, short of engineering a strong recovery with strong import demand, which is not something that is being forecasted at the moment.

**Conclusion**

The neo-classical model of growth in the CESE has been disrupted by the current crisis and it is not certain that it can be revived in the medium run. In addition, there are still significant risks that crisis may become even worse, especially if the process of deleveraging does not proceed in an orderly manner. Switching to the alternative growth model based on higher domestic savings would be difficult and would depend on the recovery of EU demand for exports from countries in transition. If that does not happen either, the return to convergence growth rates may prove problematic in the medium run.

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**References**


