

SARB takes stock and a deep breath

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Comment



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In another major landmark speech, SARB Governor Marcus last week took stock of the global economy, financial markets and the South African economy.

It was a major tour de horizon, noting global ailments and lessons, as well as, more tentatively, possible prospects.

Though money market, media, local and foreign observers were quick to conclude that some of the expressed sentiments pointed to the heightened possibility of yet another interest rate cut, prime by then dropping below 10%, the speech was primarily interesting for its broad sweep, its emphatic outspokenness in some instances and the light this sheds, if any, on SARB thinking and reasoning.

The essence of the views expressed is that South Africa faces a very challenging world environment for some considerable length of time to come. South Africans should understand the consequences thereof.

As such the speech is a very welcome “heads-up, people”.

Governor Marcus sketched a deeply divided world, splitting into a struggling developed part and a successfully performing emerging part.

Developed countries (especially the US and Europe, but also Japan) are (privately) deleveraging, constrained by fiscal austerity measures and poor public finances while becoming more regulated.

This condition probably implies (in their instances) lower growth for longer than anticipated only recently.

Emerging countries, especially China, India, Brazil and others like them, are in contrast much more successful, little impacted by the global crises (or rather so far adjusting thereto more easily) and (still) growing fast.

The message for South Africa is to fully realize the implications for us of the global crises as they affect many of the developed countries while striving to imitate successful emerging countries.

Setting The Scene

The analysis starts by describing the world economy as finding itself at a crossroads.

The 2009 euphoria about the global-recovery-being-well-underway had by mid-2010 translated into greater caution.

Evidence offered includes almost synchronized global declines in Purchasing Managers Indices (PMI), with manufacturing slowing down faster than anticipated, the IMF in 2Q2010 revising its earlier growth forecasts lower, with talk of double dip recession and greater 'fat tail' risks rife in financial markets.

Indeed, the world "probably never really emerged from the crisis which is now entering its next phase".

Comment:

This may be a particular dark interpretation of what is unfolding, especially in a week in which the IMF choose to revise its global growth forecasts higher once again. But what is required is to look through events, which is the main aspect of Governor Marcus' analysis.

The Anglo-Saxon financial crisis of 2007-2008 and the recessionary shock it gave rise to, as well as the European sovereign debt-cum-banking shocks that followed in its wake in 2010, are very real.

The global recovery since mid-2009 was also real, even if it was policy stimulus induced, and frontloaded by inventory and export repair (features which doesn't make the recovery any less real, but are they sustainable?).

As these latter features become less strongly felt, the global economy can be seen as falling back on (rotating towards) final demand (namely private and public consumption and fixed investment), further complicated by foreign trade effects.

This is a much broader front of expansion than the initial inventory and export repair.

Here it is correct to note only gradual growth at present and very low resource utilization, especially in many richer countries.

But this gradual pace in final demand was there throughout the recovery so far, perhaps hidden from view by the strong inventory and export repair effects, but for that reason no less a feature.

It isn't as if of late final demand in many parts of the world is faltering anew. Instead, it is actually more fully coming into view, a world of difference.

This may make double dips less likely than perhaps championed by some overseas observers, provided final demand can (at some point) continue under its own steam and/or needed policy support can continue to be supplied.

What is bothersome is the ongoing private deleveraging observable in many parts of the developed world and its reliance therefore on ongoing policy accommodation at a time when the limits to policy accommodation are up for discussion and possibly differently seen.

The differences in views appears to be, firstly, the sustained ability of fiscal versus monetary policy accommodation, secondly, the policy preferences of Europe versus

the US, and thirdly, the real inclination of policymakers versus the preferences of electorates and financial markets.

The Global Scene

Following aggressive fiscal and monetary policy rescues in many regions during 2008-2009, with mostly only the vaguest notions expressed about eventual 'exit' strategies, a different mindset was becoming evident by mid-2010.

(It was global bond market vigilantism that had become increasingly assertive, rejecting unsustainable fiscal trajectories, especially in distressed Club Med Eurozone countries).

This led governments worldwide to conclude that their fiscal consolidation would have to be more significant than originally thought if they in turn were to escape bond market penalization.

Thus the unfolding global reality became increasingly complex. Pimco's Mohamed El-Erian identified many strands marking this complexity.

His long list includes debt explosion in industrial countries, regulatory reform globally, struggling employment conditions in many industrial countries, political polarization and the rapid shift of growth and wealth dynamics favouring emerging economies.

In some instances, growth had become stimulus dependent, fiscally AND monetary. As financial and economic shocks induced collapse of private demand, fiscal expansion filled the gap.

But as crises played out, it materialized many private agents (households, banks) in especially advanced economies were not able or willing to re-engage quickly in supporting overall demand, largely because of impaired balance sheets.

Many households remained cautious, even beyond the initial shock. Inventory support only provided a powerful short-term boost.

The recovery process in many regions could not continue without a more sustained improvement in final domestic demand (consumption, investment).

It was a situation that called for continuing policy support stimulus.

Instead Europe, according to Governor Marcus, had already gone beyond withdrawal of fiscal stimulus. It had moved publicly to a situation calling for fiscal austerity and consolidation.

Though needed for fiscal sustainability reasons, this exit inclination was by some described as premature, potentially undermining the pace of recovery and giving thus possibly rise in some instances to growth relapses (double dips).

Marcus highlights the dire case of Greece. Reducing its budget deficit by 10% of GDP these next three years could apparently cause its GDP to drop by a cumulative 15%-20%.

Comment:

One would like to note here that Greece contributes less than 3% of Europe's population and GDP. And even if other Club Med countries are also stressed, the overall European growth condition or fiscal adjustment is not coming close to Greek realities.

There is far more regional diversity to be taken into account rather than just the worse case(s). Norway was never in recession. Sweden is growing and raising its interest rates to improve its balance. The stronger parts of Europe are all growing, Germany at 2%. The Balkan states form a class apart.

Also, though fiscal consolidation is being planned everywhere in Europe, it isn't actually an 'exit'. The overall EU budget deficit is "only" 6% of GDP (Germany is 5%, compared to the UK and US at 11%).

This EU deficit compares well with the 3% Maastricht Treaty constraint. Still, even Germany and France are looking to reduce their budget deficits by 5% of GDP.

But this is being phased in over four to six year time horizons, as is the UK's fiscal retrenchment (and pretty much everywhere else, except in the most distressed parts where the pace of reduction is faster).

This year, Europe's fiscal stance is still expansionary while the retrenchment from next year and in subsequent years will actually proceed at a very modest pace.

Also importantly, such reduction of fiscal stimulus will take place in the context of partially dismantling the welfare state, especially its disincentive aspects. This together with often drastic supply side reforms are growth positive, and are already having a growth effect as seen in Greece.

Such welfare state dismantling and supply side reforms, especially in the labour market, is of course in rather shrill contrast to South African tendencies in recent years, perhaps something to note for future reference?

Taken overall, the EU fiscal retrenchment effort appears not to be quite the growth shock as foreseen by especially some Anglo-Saxon observers.

Also, in the case of Europe, one must allow that the Euro depreciation will be growth supportive, while in the case of safe havens such as the US, Germany and UK, incoming capital flows suppress long-term bond yields to remarkably low levels, in the short-term also being growth supportive.

Europe's Low Growth

But the main point, and very much central to Governor Marcus' view, is that European growth is bound to be slow for some while.

Also, fiscal consolidation is seen as putting most of the (accommodating)

adjustment burden on monetary policy.

As a consequence, interest rates in many key regions will be low for very long, thereby also counteracting the negative growth impact of fiscal consolidation.

This leads Governor Marcus to conclude that central banks will need to continue using their balance sheets to support financial markets.

This conclusion points to a yet another kind of downside as the analysis then quotes Pimco talking of these recent financial crises as being a serial balance sheet contamination, at least in some regions:

- private sector balance sheets expanded unsustainably (households and banks), after which too much simultaneous balance sheet deleveraging threatened global depression, with governments stepping in with their balance sheets to prevent the worst
- this led to the current sovereign risk issues, with fiscal authorities now needing to deleverage
- this leaves central bank balance sheets as the only ones left to prevent any downturn

Furthermore, in Europe the German balance sheet is seen as bailing out the rest.

Comment:

Though the Pimco analysis is not taken any further, perhaps analyzing more deeply what it could mean to ultimately load central bank balance sheets perhaps overly much, leaving this thought hanging in the air, it clearly offers food for thought and presumably was intended as such, perhaps as much a reflection of global conditions as about future South African policy options currently being considered.

Meanwhile, the very last point made about Germany as sole point man in EU lifeboat operations is not quite true as France, Holland, Italy and other Eurozone countries also have their balance sheets fully proportionally committed, as much as Germany's, thereby spreading the bailout burden rather than being only a German effort (the latter view being perhaps primarily a notion of many German taxpayers but not necessarily true).

Risks and Concerns

Governor Marcus highlighted certain popular concerns:

- market (and even some central bank) concerns about inflation. These are described as premature, given large output gaps, but it was noted, with obvious concern, that there are limits to what can be done by monetary policy on its own (reminding of past South African experiences?)
- there is the temptation to solve debt crises through monetization
- politically, social contracts (welfare states) are under pressure (Europe). In distressed Club Med countries the price of adjustment is a strained social

fabric as wages are lowered and/or jobs lost. Elections resulting in weak coalition governments reflect lack of social consensus going forward.

- There follow yet more structural/social problems, as part solution of the fiscal (pensions) crisis is to lift the retirement age, but thereby worsening youth unemployment at a time of slow growth and little additional job creation.

Growth would be the easiest option out of this fiscal crisis, but growth is likely to be lower for longer as well, at least in the fiscally worst affected countries.

Regional Concerns

In the short-term, Europe is by far the biggest concern. For a monetary union (fixed exchange rates between the members) to be successful, one needs a credible fiscal union with enforceable limits.

Growth (and blinkers everywhere, just as earlier in Anglo-Saxon banking) papered over the decline in peripheral trade competitiveness, fiscal and trade deficits remained financed, with Club Med sovereign debt seen as the same risk as core countries.

One is left to ask, as with subprime mortgage lending before (and much off-balance sheet bank financing), why it took financial markets so long to wake up?

Comfort zones were apparently created, sustained by growth perceptions refusing to accept less rosy interpretations of reality until far too late.

According to Governor Marcus, fiscal adjustment in Europe/UK means growth will be very low for some time, if not negative.

Comment:

While this is very true for some parts of Europe, this view may not be taking enough account of the diverse experiences observable in Europe today as mentioned earlier. At least some countries are seen as having stronger growth, Germany being mentioned but being only one such example, with the proviso they don't require much fiscal adjustment (Scandinavia), are able to increase productivity (Germany, Holland) and benefit from a weak Euro (all do, Greece apparently more than Germany, with 56% of Greek exports going outside the EU as compared to 40% for Germany).

American Concerns

Europe isn't the only regional concern of Governor Marcus. In the US, consumption recovery is slow as high unemployment, a deleveraging bank sector, weak housing market and excessive personal debt (and shaken mindsets) constrains households.

Comment:

For this reason one notes the ongoing posture of the Obama administration of wanting to maintain fiscal stimulus, with requests still forthcoming for extension of unemployment benefits and more state aid.

It is considered premature over there to start fiscal consolidation now, even though Fed chairman Bernanke advises early signaling regarding future exits in order to keep bond vigilantism contained.

In any case, from next year the Bush tax cuts start falling away, stimulus measures run out (unless extended, with a large probability of this happening) and the growing economy will boost tax revenue, between them starting US budget deficit reduction.

China

China, most of Asia generally and some Latin American regions remain growth poles, even with a policy-induced slowdown in China. Though China's outlook still suggests 9% growth, some see this as reinforcing an increasingly negative global market outlook.

Comment:

Such reticence abroad about Chinese growth contribution to global performance may well be overdone, with the Aussie central bank for instance earlier this month suggesting the Chinese growth story remains on track (if somewhat slower).

But such citations nevertheless form part of a picture bringing together the European, US and Asian conditions and as such giving rise to increased (market and policymaker) unease.

This, however, is also a rollercoaster sensation that isn't unusual in the early stages of any cyclical expansion.

What makes the current situation perhaps more noteworthy, are the major crises that have occurred and their aftermath still unfolding, with apparently reducing degrees of policy freedom to address lingering underperformance, never mind having to address new shocks if any were to occur.

South African Outlook

With this global view as backdrop, Governor Marcus described the South African economy as recovering BUT also hesitant, fragile and uneven.

Externally, South African growth sustainability is seen as a function of global recovery, Europe especially (absorbing one-third of our manufactured exports).

Internally, our growth is a function of infrastructure and human capital investment.

Happily, South Africa has only a small direct exposure to distressed Club Med countries, being only 5% of our (manufactured) exports. But any slowdown in Europe would not be inconsequential for South African exports.

Comment:

Even so, one notes European growth forecasts being reduced from 1.7% this year to nearer 1.3% (IMF and therefore possibly being too pessimistic). Though such slower growth is unwelcome, this isn't necessarily catastrophic, as compared to the terrible GDP contractions apparently facing a country like Greece.

Our 4.6% South African Economy

Governor Marcus describes South Africa as presently having a 4.6% economy – annualized growth and current account deficit in 1Q2010 being 4.6%, while CPI inflation fell to 4.6% in May.

This, though, many not remain the case for very long.

The output gap is described as wide and likely taking time getting back to pre-crisis levels.

Our GDP growth is positive, but will remain much slower than many Emerging Countries.

Interestingly, many South African analysts recently downgraded their (previously too optimistic) growth forecasts, given global developments and PMI (in line with overseas example), while SARB now expects 3% growth in 2010 from 2.7% previously (thus nearly everyone now sitting on one line for the first time).

Manufacturing is described as leading the recovery since mid-2009, this being mainly an export recovery. The outlook is therefore a function of global prospects, with manufacturing output currently slowing down (its growth recovery giving the impression of topping out).

This presents downside risk to the 2H2010 growth outlook.

It was noted that fixed investment is now nearly stagnant in the public sector (with no outlook mentioned), while contracting in the private sector (being a concern).

Household consumption has turned positive, but after a strong 1Q2010 some moderation is expected, considering low credit growth.

The inflation outlook is favourable, with 4.6% now and to remain within target during the forecast period, though moderately rising from 4Q2010.

This made it possible to reduce the nominal repo rate to 6.5%, the lowest level since the late 1970s.

It isn't unusual for employment to lag early in business cycle expansions BUT there are also structural impediments. South Africa lost disproportionately many jobs during this recent recession, with wage settlements remaining well above inflation (especially in the public sector).

If not matched by improved productivity, there will likely be inflation consequences.

One could note here that the higher unemployment accompanying the GDP growth recovery does indicate there ARE productivity gains taking place, though not necessarily in the public sector.

Governor Marcus expressed a deep truth stated far too infrequently in a highly competitive world, namely that South Africa cannot wish for employment creation AND agree to wage/salary settlements of often double (or triple) inflation (unless of course remuneration was slashed during the 2009 recession, perhaps not evident in the public sector or many unionized settlements but certainly in large parts of the private sector, especially in managerial ranks).

Given the preceding global analysis and South African realities, one appreciates the Governor's call that South Africans need to understand better the global financial crises and their consequences.

It leads to the conclusion that this requires from all of us greater interaction, common purpose and an appropriate course of action as a nation to stave off the worst ravages of the global crises.

It asks for greater coordination/cooperation between policies (rather than infighting). Apparently loose monetary/fiscal policy and weaker Rand are NOT recommended ("not possible to have"). For such a policy mix will NOT depreciate the real Rand but it WILL give higher inflation.

Hardly a hint of another interest rate cut here, surely? But then central banks have been known to change their views before (most lately in spectacular fashion the ECB in the manner it ultimately reacted to the latest European debt and banking crises).

Instead, Governor Marcus would prefer a good mix of macro and micro policies yielding higher productivity, growth and employment with low inflation, presumably meaning mostly the approach favoured in recent years.

Central Banks

It is furthermore stated that globally central banks have acquired additional responsibilities, explicitly or implicitly. It is an intimidating list and gives only a hint of the modern complexity facing any central banker, including ours.

For central banks are expected to be able and willing (not the same thing) to deal simultaneously with:

- macro prudential
- micro prudential
- financial stability

- crisis management
- provision of liquidity

And doing all of that while also delivering on its core responsibility of independently executing monetary policy.

All of this was bound to hold some lessons. The two important ones are:

- financial stability crises build up over years. It is much harder to restore stability once this has been lost
- need for coordination/cooperation between
 - central banks
 - governments
 - markets
- within a sound regulatory environment with the aim of maintaining systemic stability.

Do those lessons really sound like offering potential for another interest rate cut soon?

Financial markets seem to sense such potential, yet the real attempt of the entire speech seems to be to point out the current global dangers, South Africa's exposure and the need in such a divided world to model ourselves on the more successful overseas examples (other emerging countries, the BRICs in particular).

Especially labour market behaviours in this respect come in for closer scrutiny and pointed criticism which the country will do well to take to heart and which presumably are already frequently a point of discourse for the Governor when meeting public and private sector managements and representatives from organized labour.

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