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Recent Financial Market Turmoil and Implications for South Africa

University of Stellenbosch Business School

Bursary Fundraising Dinner

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Introduction

Thank you for the opportunity to address you this evening.

I address you today on an historic day for our country. It was thirty years ago today that Steven Bantu Biko was killed by the South African police. He was just 30 years old, at the prime of his life; passionate about literature, academia, identity, equality and human rights. If Biko were alive today, I am pretty sure that he would either be a member of the government or a prominent theoretician on the dynamics of our society. Yet, history is curious way of testing who we are – the chances are that more people in this audience recall the events in New York of 11 September 2001, than the profound tragedy of the death of Steve Biko. That is an important discussion we should preserve for another day.

Members of a university community are in the fortuitous position where they can develop and engage with the theories of society and at the same time reflect on their experiences from their own backgrounds. Biko was able to combine passion for the rights of people with an ability to understand society that belied his tender age.

Over the past month, global financial markets have experienced heightened turbulence driven by a tightening of credit conditions and an increase in the price of riskier assets in global credit markets. The wave of turbulence was triggered by rising defaults in the US sub-prime mortgage market, and has directly affected hedge funds, investment funds and the commercial paper market, and had knock-on effects on equity and currency markets around the world.

This volatility should be seen in the context of the slow unwinding of global imbalances – the pattern of large current account deficits in some countries such as the US and surpluses in China, oil exporting countries of the Middle East and elsewhere. Open to the back page of The Economist magazine in any given week, and marvel – look at current account balances – USA has a deficit of 5.8% of GDP at a staggering $ 804 Billion; China has a surplus of 10.7% of GDP valued at $250 Billion; or Saudi Arabia's surplus is 25.8% of GDP valued at $ 99 Billion, or our own, a deficit of 6.2% of GDP at 16.6 Billion dollars. There are these huge imbalances with no international agency to deal with or regulate them. Truly, this is globalisation without global institutions of governance.

Rising interest rates in the US, which are needed to increase saving there, have revealed the inability of many households to continue to finance large mortgages.

Sub-prime debt has been packaged and sold to foreign investors, creating the link for international financial contagion from the US economy to the rest of the world.

These contagion effects indicate how advanced the process of financial globalisation has become. In the 1980s, problems in the US housing market might have resulted in a run on one or two large US banks. Instead, the current US sub-prime mortgage crisis is having an impact on financial markets across the world, including South Africa.

Current market developments unfold against the backdrop of a spectacular build-up of global liquidity in recent years – referred to by Chairman Ben Bernanke of the US Federal Reserve as the *global savings glut*,[1].

The savings glut was said to be *"driven by the transformation of many emerging market economies – notably rapidly growing East Asian economies and oil producing countries – from net borrowers to large net lenders on international capital markets".*

According to Bernanke, the glut in global savings helped to explain a number of related developments in the global economy, including the substantial rise of the US current account deficit, the huge expansion in current account surpluses in emerging market economies, and the world wide decline in long-term interest rates. We might further add the role played by the US monetary system as lender of last resort in the successive financial crises of the 1990s and 2001 as contributing to globally low interest rates. Asset price inflation in major world economies, especially the US housing market, further elicited credit expansion as household debt to asset ratios fell over time.

This increased liquidity and the savings glut introduced a degree of comfort and, in some cases, complacency in financial markets not seen in decades. This complacency in turn led to more complex and riskier financial instruments, at times out of touch with reality. Financial analyst appeared to be driven by their computer-based models rather than real economic variables.

The current market correction may be part of a process of reducing the scale of global imbalances, which would require a combination of slower US consumption growth, a weaker dollar, a slower build-up of savings in emerging markets and a repricing of Asian exchange rates. As this process unfolds, various markets will experience volatility, especially those that have exhibited asset price inflation in recent years.

We need to recognise that while the process of rebalancing will lead to temporary changes in global growth, an orderly unwinding of imbalances is necessary in order to maintain the unprecedented strong global growth path over the longer term.

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[1] Bernanke, B. 2007. "Global Imbalances: Recent Developments and Prospects". Speech delivered at the Bundesbank Lecture, Berlin, Germany.

Unpacking the crisis

A prolonged period of low interest rates around the world has led to a surge in global portfolio flows and encouraged increased risk taking and borrowing by investors. Assets under management of institutional investors more than doubled in the decade between 1995 and 2005 from US$21 trillion to US$53 trillion.

Investment in alternative vehicles such as hedge funds has also increased sharply, with assets under management by hedge funds reaching US$1.4 trillion at the end of 2006 from US$30bn in 1990. It is estimated that roughly 50 per cent of oil revenues in the current commodity cycle are saved and reinvested into the global financial system, which has led to a quadrupling of reinvested oil revenues from US$90 billion in 2002 to over US$400 billion last year. Reserves accumulation by emerging markets, in particular Asian countries, has also contributed significantly to global capital flows.

And, as these huge positions built up, few considered the risk of fall out and Alan Greenspan's counsel against "irrational exuberance" appears to be advice to an earlier generation.

Turning to the specific events playing out in the US… the anatomy of the credit crunch can be explained in the following way.

Between 2001 and 2006, the US housing boom encouraged excessive risk-taking by lenders, who sharply expanded loans to marginal borrowers. Financial innovations such as automated underwriting[2] and securitisation were key components in lowering the costs of sub-prime lending. These financial innovations combined with historically low interest rates fuelled US house purchases, reaching even those who previously could not afford property. During the peak of the market six months ago, sub-prime loans accounted for more than 13 per cent of the total US mortgage stock.[3]

The rapid rise in mortgage defaults initially affected specialist mortgage lenders in the US. But, as Warren Buffet once said, (and I paraphrase) when the tide goes out, you can see who has been swimming naked – commercial and investment banks also

[2] Automated underwriting (using computer models rather than loan officer judgment) has made loan origination more cost efficient, while advances in statistical credit scoring have led to more accurate and consistent assessments of borrower credit risk.
[3] V. Luvhengo and G. Marincowitz *Global Financial Market Crisis*, National Treasury, August 2007.

declared losses from holding sub-prime mortgages outright or interest in securitization transactions they arranged.

Further liabilities held by a range of pension and hedge funds and foreign banks also went into default, spreading the losses to foreign markets. Indeed, the current crisis was sparked by the need for liquidity by a French bank.

The financial innovations that fuelled the sub-prime mortgage market in the first place, also contributed to the swift transfer of the costs associated with default to investor institutions around the world.

As broad portions of the credit market became subject to extreme risk aversion and low levels of liquidity, it became necessary for central banks in the US, Europe and other developed markets to inject liquidity into the overnight money markets. During three high-pressure weeks in August, over US$400 billion was provided to the markets by central banks in the USA, Europe, Japan and Australia.

These actions by central banks have been crucial to maintain confidence in the banking system and to reduce the potential impact on the real economy. Apart from providing additional liquidity to money markets, central banks in Europe and Japan have also held off on monetary tightening despite earlier intentions to hike interest rates.

However, the response of central banks to the current market crisis has raised the issue of moral hazard in financial markets. While there appears to have been a mispricing of risk in credit markets for some time prior to the current troubles, there is an expectation that central banks will step in to ease potential losses on bad investments. Has the response of monetary authorities papered over the cracks in the financial sector? Chairman Bernanke has emphasised that it is not the responsibility of the Federal Reserve to protect lenders and investors from the consequences of their financial decisions, but central banks also have a responsibility to respond to potential spillover effects of financial market troubles to the broader economy. A huge debate has been unleashed amongst economists – some, such as Martin Wolf, the respected Financial Times columnist argued strongly that “Central Banks should not rescue fools” – the fools being those financial institutions who engaged in dodgy practices; others like Nouriel Roubini argue that we should work past the institutions and bail out the individual homeowners. I would hazard that the debate on moral hazard will rage for some time yet.

Investors have also lost confidence in traditional methods of assessing risk and the lack of accurate information. Ratings agencies in particular have come under fire for inadequate disclosure of information and understating the riskiness of subprime mortgage paper and collateralised debt obligations (CDOs), making potential buyers suspicious of structured products. The distrust of credit ratings today has parallels with the situation at the time of the corporate accounting scandals in 2002, when investors felt that they could not trust corporate financial reports. As we know, that crisis eventually led to a comprehensive overhaul of corporate governance rules and accounting standards.

This has raised questions about the quality of oversight and regulation in the US banking system and hedge fund industry. It is clear that many investors had insufficient information to understand the underlying risks associated with complex structured products being sold by banks and this ultimately contributed to a mispricing of risk in credit markets.

Warren Buffet, when talking about similarly complex financial instruments said the following, "Derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal, posing risks for the entire economic system." [4] We live in a world where we've been led to believe that markets are always right, that financial analysts know better and that risk is transferred to those who can manage it best. The truth is often far from this.

Implications for the rest of the world and South Africa

What is the implication of all of this for the world economy and South Africa? The past four years has seen a period of unprecedented growth in the global economy supported by low real interest rates and optimism in financial markets. Between 2003 and 2006 world GDP growth expanded at an average pace of 5,0 per cent after only 3,5 per cent in the previous four years. The outstanding feature of this performance is that growth has been broad based across developed and emerging economies.

Macroeconomic stability has been enhanced by the move towards floating exchange rates and inflation targeting in many countries, and has contributed, alongside high commodity prices, to the flow of capital into emerging markets and developing

[4] An excerpt from the Berkshire Hathaway annual report 2002.

economies. Although global imbalances have persisted, the current dislocation in financial markets could hold the key to future rebalancing via slower growth in US consumption, a weaker dollar and reduced capital flows to emerging markets.

The global economy has displayed increased flexibility to shocks of the size witnessed in recent weeks. Improved macroeconomic policies in a broad spectrum of emerging market economies have played a key role in minimizing damage so far. Although the spillover effects to the global economy from tightening financial conditions are still being assessed, countries with solid macroeconomic fundamentals are better placed to weather the market storm than others. In particularly, those with high foreign exchange reserves and current account surpluses, as well as those with flexible exchange rate regimes, inflation targeting and responsible fiscal management are likely to perform better.

South Africa has done well so far, and should continue to do so unless there is a significant slowdown in global growth that leads to a rapid fall in commodity prices. Such developments would be of concern given that we are currently running a current account deficit in the order of 6,2 per cent of GDP. However, the macro underpinnings of the South African economy remain sound with growth remaining broad-based and investment rising.

South Africa also has embedded in its immune system, lessons from previous crises, notably fallout from the 1998 Asian crisis and the collapse of the rand in 2001.

Local banks have also indicated that they have little or no exposure to the cause of the trouble – sub-prime lending or to hedge funds with sub-prime assets. Furthermore, the banking system is well regulated with constant supervision and adequately capitalised.

Fiscal and monetary policies are also flexible enough to address negative economic shocks should they occur. Prudent budgetary decisions have created fiscal space and resources for countering negative shocks. On the monetary side, the inflation targeting framework provides the scope for the Reserve Bank to assess the sources of inflationary pressures and the floating exchange rate creates a cushion for the real economy when rand assets are sold by non-residents. In addition, the accumulation of foreign exchange reserves significantly reduces our external vulnerability.

Conclusion

In conclusion, ladies and gentlemen, the correction in asset prices that we are seeing presents both threats and opportunities to investors around the globe and raises important questions for policy makers regarding the adequacy of oversight and regulation in the banking sector and global hedge fund industry.

The combination of financial innovation and excess global liquidity over the past few years has resulted in an ever more complex array of structured credit products being made available to consumers and investors, but there appears to have been inadequate disclosure by banks and ratings agencies regarding the underlying risk to these investments.

For South Africa, we remain confident that our monetary and fiscal frameworks provide sufficient and needed flexibility to maintain a healthy pace of economic growth despite the financial turmoil. Should world growth slow, South Africa will of course not be immune, but as global current account imbalances unwind, the sources of world growth will continue to slowly change.

Our policy approach continues to focus on building up our cushion both so that we can benefit from globalization and more importantly, so that we can protect our people and our markets from turmoil in the global financial markets. South Africa is well placed to weather this storm.

I thank you