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The world economy in crisis

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18 November 2008

Colleagues,

The global economy is presently living through its deepest crisis since the Great Depression of 1929. Around the world, people's representatives like ourselves are engaging with the impact of this crisis on their respective mandates. I want to express sincere appreciation for this opportunity to address the National Assembly on what we know about this crisis. Earlier today we had an opportunity to discuss these matters in great detail with the members of the Portfolio Committee on Finance. Important as those discussions were found to be, we recognise that the challenges before us cannot be confined to one or other portfolio committee – the nature of the challenges is such that they affect the very fundamentals of all of our work – the crisis gnaws at the contract that we have with the people of South Africa; indeed it compels us all to ask about our ability to contribute to a deep and durable democracy that will lift millions of our people out of a life of grinding poverty.

First and foremost, this is a crisis of the developed world. Loose credit extension in the years since the dot-com bubble burst in 2001 and large fiscal

deficits in the US have increased the debt of households and governments alike. These debt levels have become unsustainable. The popping of these bubbles has had and will continue to have a large global impact.

Many countries not at the centre of the current turmoil will suffer terribly and tragically. As firms in developed countries strive to repair their balance sheets, they tend to sell everything and repatriate resources back to their home base. This has implications for us as it has for many emerging economies, despite the fact that the epicentre of the crisis does not lie on our shores. The depreciation of our currency, the rand, in line with many other emerging market currencies is testimony to these developments.

Of particular concern is Africa. Strong rates of growth in recent years are at risk as commodity prices fall and countries are forced to pay back capital. These fears pose the risk that there will be greater demands for protection from fearful populations and, less benignly, cynical adventurers. This is the state of the world, and it cannot be allowed to continue.

Recent events

The causes of all this can only be paraphrased here today. Over the years, banks purchased vast quantities of loans used for house purchases in the United States. As interest rates were increased in 2006 and 2007 in that country, many of those debtors began to default, putting at risk the value of all the housing loans. This uncertainty has resulted in the share prices of financial and non-financial companies falling, affecting lending operations between the banks.

Financial institutions involved in property, such as Northern Rock, failed, while other institutions experienced increasingly large losses on their investments in the housing markets. Losses of $200bn were predicted in the early days of the crisis. Estimated losses now stand at an estimated US$1.4 trillion, according to the IMF.

Central banks in advanced economies responded by announcing coordinated action to address short term funding markets, establishing temporary currency swap arrangements, and injecting liquidity into the markets. Sovereign wealth funds were tapped for funding for UBS, Morgan Stanley and Merrill Lynch. Interest rates have been cut sharply.

These actions did little to stem the tide however. Investment banks in the US failed (Lehman Brothers), were bought for a song (Bear Stearns), or changed their regulatory stripes to access a deposit base (Goldman Sachs and Morgan Stanley). The US Federal Reserve provided AIG, a large insurance company, with support of approximately US$150 billion, made up of an initial equity stake of US$40 billion and the difference in various liquidity support measures.

Governments have committed about $4 trillion to support financial systems around the world. About US$661 billion of write-downs and losses have been acknowledged so far.[1]

The signs of spreading economic malaise are abundant:

- In the quarter to September 2007, Volvo sold about 42 000 trucks. In the same period this year, they sold just 175.

- The cost of dry bulk shipping charter rates (as per the Baltic Index) plunged 71.9 per cent in October.

- General Motor's share price has fallen 88 percent this year, to US$3, its lowest price since 1946.

- GM, Chrysler and Ford have requested a US$ 25 billion bailout as car sales in the US dropped 32 percent last month compared to a year earlier.

The world's equity markets have declined precipitously. Since October 1, 2008, the US Dow Jones Industrial Average has fallen by about 36 percent. Brazil's Bovespa has dropped by 45 percent. Russia's RTS has declined by 71 percent. Our JSE All Share Index has fallen by roughly 30 percent.

One of the great sources of ballast in the world economy has been the rapid economic growth of China, which has contributed on average 20 percent of world growth in the last 5 years. With a gigantic population and rapid economic growth, China has been both a great importer of raw materials and commodities from the rest of the world and a great exporter too. China's demand for commodities contributed to the commodity price boom the world experienced over the past 6 years.

But growth in China has begun to moderate, resulting in lower imports and putting downward pressure on commodity prices. Chinese GDP growth slowed to 9.0 percent in the 3rd quarter 2008 from 11.9 percent in 2007 and 11.6 percent in 2006. The IMF forecasts Chinese growth of 8.3 percent in 2009.

Commodity prices have responded quickly. The price of platinum has dropped 47 percent since January 1. Gold prices have fallen by over 13 percent. And oil

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[1] And concentrated in the United States and Europe:
US = US$410 billion, Europe = US$224 billion.

Wachovia	US$97 billion
Citigroup	US$68 billion
Merrill Lynch	US$58 billion
Washington Mutual	US$46 billion
UBS	US$44 billion

prices have dropped by 31 percent. Coal prices remain 40 percent higher than they were in January, but have declined by 31 percent since October 1.[2]

Falling prices for oil and other commodities and the major outflows of capital from emerging markets in the middle of October signaled that we have entered a new phase of the crisis. Economic conditions have deteriorated worldwide. Despite this, the global economy will continue to grow in 2009, with all of the growth deriving from developing economies.

- World output to fall from 5.0% in 2007 to 3.7% in 2008 to 2.2% in 2009.
- Advanced economies GDP growth at 1.4% in 2008 and -0.3% in 2009.
- African growth expected at 5.2% for 2008 and 4.7% for 2009.

Impact of the international environment on South Africa

Commodity price changes alone have ambiguous effects on South Africa, but we should be under no illusions about the fact that our economy will suffer along with the rest of the world. The financial crisis is giving way to a real economy slowdown. Some countries will bear the full brunt of both the financial crisis – lending and borrowing has come to a halt – and the economic crisis – exports and imports will fall.

In South Africa we have experienced at least part of the financial shock. Our exchange rate has depreciated sharply and the prices of our equities and bonds have fallen far. Yet our sound and well-regulated banking system is not dependent on foreign lines of credit and our exposure to toxic assets has been nearly non-existent. Some firms with extensive international operations have seen losses, but even these have been small. Our public debt levels are low and our level of foreign currency debt is even lower. This helps to lower our vulnerability to financial shocks.

Global economic weakness in trade and investment however will have more far-reaching effects. Declining commodity prices and lower growth in major trading partners will lower demand for South African exports and reduce the income we derive from them.

Only one part of our challenge is to ensure an appropriate short-term response. In the long-term, we need to ensure that our firms and our people are more productive, more export-oriented, and have higher saving and investment rates. We need to be able to achieve much higher economic growth rates with a sustainable current account.

[2] IMF food price index peaked in May 2008, 50% higher than a year earlier. Since May, food prices have declined by 14%.

It is becoming clear, however, that at least in the medium-term, our aspirations for more rapid economic growth and our capacity do not match.

Our policies have been appropriate to our macroeconomic challenges in recent years. We have set a monetary framework that targets a low and stable rate of inflation over the long-term. As a small economy we can expect that inflation will sometimes fall outside the target, and we have experienced such an occurrence this year and last from sharply rising food and oil prices. We are not alone in this – nearly all countries have missed their implicit or explicit inflation targets over this period. What matters is that we have a framework that is flexible enough to ensure that we re-achieve low inflation over time and with due regard for economic growth. The economic and social costs of a prolonged period of high inflation or deflation caused by wayward or ill-conceived monetary policies cannot and should not be tolerated by a democratic society.

On the fiscal side, we have endeavored since 2005 to raise saving in the economy and create fiscal space. We did this for two reasons. One was to offset the negative effects of rapidly-growing domestic demand on inflation and the competitiveness of the economy. The other was to create financial savings to expand demand should economic growth fall sharply.[3]

At this point in time, we can prudently maintain a healthy growth rate in government spending while keeping public borrowing modest and sustaining low long-term interest rates. As growth slows, however, it is likely to become more difficult to maintain a positive government saving rate. Continuing to focus spending on capital and public infrastructure helps to keep saving up, and so we have opted to continue to emphasise our public infrastructure commitments – the expansion of our energy production capability and to ensure readiness for the World Cup, among others.

Our good track record in financing investment in human capital – in health, education and skills development – will also be maintained. These commitments will help to raise the economy's growth rate in the present as investment spending is maintained, and in the future contribute to rising potential growth of the economy.

To close the gap between the 6 percent economic growth rates we aspire to and the realities of slower growth we are now experiencing requires a renewed effort to reform our economy.

Reform is needed to propel investment. Purchases of South African bonds and equities by foreigners accounted for almost half of South Africa's financing needs between 2002 and 2007. About US$20 billion per year is needed to finance the current account deficit. Continuing to attract foreign investment implies the need

[3] That is below the rate of growth that provokes inflation or an unsustainable current account deficit.

to maintain confidence in our macroeconomic policies *and* raise the growth rate of the economy.

Our dependence on foreign savings can be reduced over the long-term, but the only way to do this sustainably is to export more – to produce goods and services more productively and at lower cost than before and sell them abroad. This is where economic reform needs serious engagement by South Africans to make good long-term decisions.

There is no shortage of good and bad ideas. Our task is to find the good ones and move forward with policy articulation and implementation. Raising the cost of economic activity and restricting our ability to trade is not the right path for South Africa. We live in a world where our domestic industries, such as the domestic auto or metals industries, are intimately and irrevocably linked to the rest of the world. The indiscriminate dispensing of cash to firms that lobby for help will also not raise incomes and create jobs. We have made financing available for industrial policy – it is time that economically-sensible plans are articulated for public review and support.

Our focus on government's contribution to reducing the costs of economic activity and expanding infrastructure needs to be matched by investment and productivity growth in the private sector.

There is room for policy adjustment in a range of sectors to facilitate investment in new businesses and growth in employment, particularly in network industries. New power generation, greater responsiveness to environmental needs, expanding our access to advanced telecommunications, the redevelopment of water and transport infrastructure, among others, imply fertile ground for private and public partnership and new economic activity.

Let us be clear – the global crisis enjoins us to take forward our efforts if we intend to permanently reduce unemployment, increase incomes, and lower poverty. Our macroeconomic policies are sufficiently flexible to address a prolonged economic downturn, as demonstrated in the shift to a fiscal deficit in the MTBPS. We have a good understanding of what the international community is doing to combat economic weakness, and we understand the need to address our local economic challenges.

<u>Reform of our international institutions</u>

Our domestic efforts to address the global economic crisis need to find external resonance in the reform of the international financial architecture, in the reform of our multilateral institutions, and in the renewal of global commitment to mutual accountability. A coordinated international approach to the financial sector is also needed.

The international financial and economic crisis is in large part about the failures of national and cross-border regulatory regimes in assessing and managing the

risks building up in financial institutions and systems. In Sao Paolo and Washington, at the G20, we discussed how to address these problems in a durable and credible way in coming months. On a national basis, it was noted that policy frameworks need to maintain fiscal sustainability – there is little gain to be had from a new massive build-up of imbalances. We cannot allow a crisis caused by a rise in debt and cheap credit to be followed in 10 years time with another crisis caused by the same thing.

To make headway, Ministers of Finance and Central Bank Governors have been asked to look at a range of issues in the financial markets, with deadlines set for next year. Particular attention needs to be placed on sound regulatory policies and the application of standards for accounting, auditing and transparency.

Each country will therefore have to develop its national plan, based on the common principles for reform. We will each have to assess to what extent both our fiscal and monetary policies support the internationally agreed principles. More importantly, we will need to ensure better co-ordination and co-operation not only between our own financial regulators, but between our regulators and those of other countries, particularly in regulating financial institutions that operate in more than one country. I will be convening a meeting of all our financial regulators, as well as the SA Reserve Bank and National Treasury, to ensure that as South Africa we give effect to the common principles for reform, and to facilitate our full participation in global standard-setting institutions and the Financial Stability Forum.

Colleagues, allow me to conclude. We have the good fortune of being able to stand on the shoulders of those who preceded us, and so we understand much about what has gone wrong in the world economy and what is required to deal with it. The effects however will be with us for the foreseeable future, and so we need to think carefully about how we reach our own domestic economic goals in this new environment. Our macroeconomic framework is sound and because of the choices we have made in the past, we have the resources and policy space to set an appropriate response to the evolving economic downturn.

We need however to address the microeconomic and regulatory constraints to more rapid economic growth. This implies a renewed social dialogue, one part of which will be the development of a national approach to financial markets regulation and reform. But addressing our long-term growth and employment challenges requires a broadening of that dialogue. Much needs to be done to achieve our aspirations of a country without poverty.