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Moving beyond macroeconomic imbalances and regulatory myopia…

How can the developing world respond to the global crisis?

Address to the Helen Suzman Foundation/Gordon Institute of Business Science

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Introduction

Thank you for inviting me to speak to you today. I believe it is an appropriate occasion for me to extend a word of appreciation to you for creating such a vibrant and active forum for public discussion, which further deepens our culture of democracy.

Let me begin by positing a radical suggestion – I am confident that the global economic crisis will in due course give way to a more robust and more enduring era of economic development in Africa and the developing world than we have hitherto contemplated. Stronger economic development in the countries of the

South is not a new event. It has roots that go back a decade or two, and it has several inter-connected strands:

- The extraordinary economic growth of China and India and the sharp decline in the number of people living in poverty worldwide.
- The sustained rise in commodity prices, reflecting much more broad-based industrialisation and modernisation and associated demand for infrastructure and traded goods and services.
- The rapid increase in the use of new, lower cost and efficiency-enhancing information and telecommunications technologies.
- The rise in urbanisation rates and mega-cities across the developing world, and rapid increases in education and technology adoption.
- Greater macroeconomic stability in much of the developing world, including several leading African economies.

Although growth may be interrupted for a period, these are powerful dynamics and they are not going to be reversed. In some respects the structural imbalances that underlie the present crisis are constraints to broader development, and so the resolution of these imbalances is a condition for more sustainable growth and prosperity. These are not just economic dynamics, or changing trade and financial relations. Structural change is also about the evolution of institutions:

- There is, worldwide, a welcome (though sometimes troublesome) decline in political timidity, a strengthening of people-centered democracy, and a willingness to pursue reforms within developing countries.
- There is an opportunity now to re-shape the international financial and developmental architecture to bring about both greater transparency and better resource flows to support the developing world.

- Alongside the restructuring of trade and financial relationships we will begin to see better management of earnings disparities and, over time, greater fairness in labour market outcomes across the world.

These are trends that will complement other economic transitions: South-South economic links will strengthen, and in Africa a renewed impetus to reform intra-African economic barriers and commitment to cross-border public infrastructure will assist in supporting growth of markets.

Institutional evolution and overcoming barriers to broader economic development are not automatic, elegant trajectories however: the process will be uneven and for now we have to contend with a series of grave challenges associated with the current crisis, in particular the economic damage caused in the short-term by declining capital flows, rising macroeconomic instability, and job losses in vulnerable societies. Raw statistics cannot capture the magnitude of these adjustments, but the numbers are nonetheless startling:

- The World Bank estimates that 53 million more people will fall below the level of extreme poverty in 2009 and an additional 32 million people will lose their jobs in emerging countries in 2009.[1]
- The ILO estimates that the global number of unemployed will increase from 190 million in 2007 to 210 million in 2009.

The G20 dialogue

Over the past few weeks there has been something of a turnaround in markets internationally and in South Africa. I wish I could report that the G20 Leaders' meeting last week and the process leading up to it have diagnosed the problem, identified the remedies required and agreed on an appropriate burden of

[1] Extreme poverty: person living on less than $1.5 per day.

adjustment. I would love dearly to tell you that the world economy is now reviving.

There are tentative indications of a recovery, but this is not just about a new direction in financial market trends; there are also deep-rooted structural imbalances and massively distressed institutions which will take considerable time to be resolved.

Rising new orders and the continued sharp decline in inventories, reflected for example in the leading purchasing managers' indices of production, provide encouraging signs of improvement in global manufacturing. Sharply lower inventories, among other things, suggest that consumption of intermediate and final goods is now increasing. As inventories deplete, firms need to increase production to meet ongoing demand. The data underlying these developments come out of the US economy and a range of emerging markets, including China, Korea, Taiwan, Thailand, Brazil, and others.

The corresponding indicators in Europe and other parts of Asia are, however, less encouraging, and suggest that the sharp plunge in economic activity in the centres of the crisis is still working its way around the globe, and may be followed by a succession of after-shocks. The impact of these waves of retrenchment on employment is perhaps our most critical concern because of the effect job destruction has on aggregate demand.

The world still needs to fight through these turbulent tides, and the under-currents are powerful and unpredictable. Part of doing that requires governments to demonstrate not just a capacity to reach diplomatic agreements, but also to implement difficult fiscal and financial adjustment programmes, often of unprecedented complexity. It is not enough to diagnose what is wrong, it is also necessary to design a response and construct the institutional capacity required for its implementation.

We are fortunate in that there have not been major shocks to our banking system, and the institutional implementation of our fiscal response very largely builds on plans and capacity that is in place, and infrastructure projects that are in progress.

But I can also report that President Motlanthe and I came away from the G20 Leaders' summit in London last week heartened by both the substance of engagement with extraordinarily difficult policy issues and the willingness of global leaders to think differently about the challenges of financing development.

I don't want to pretend that the world's structural trade problems have been dealt with or that there are not important differences of perspective between global leaders. Even the most immediate challenges of stimulating global demand and dealing with the non-performing assets on major financial institutions' balance sheets evoke sharply contrasting analyses and opinions amongst the major protagonists. There are different views on how the regulatory systems should evolve and on what kind of re-shaping of financial institutions and markets we should pursue.

It is not that the G20 is unfamiliar with the structural issues: it was in this forum that the issue of global macroeconomic imbalances was recognised and defined as a serious impediment to world economic stability several years ago. The implications of those imbalances for financial stability and international financial contagion were extensively and intensively discussed. The IMF and external observers of the global economic trajectory issued warnings over the inconsistencies building up in key economies. They pointed out the risks accruing to the developing world, which had benefited from the flow of capital looking for higher returns and the boom in commodity prices driven by growth in China and elsewhere. Too little of these discussions has filtered through to multilateral action or to national authorities and their assessment of domestic monetary policy or financial regulators.

Credit rating agencies implicitly validated the underlying view of the protagonists that the world could go on forever with the US and the UK over-consuming and China over-exporting. The search for yield on investments took progressively less account of the risks associated with the assets being sold to investors. And underpinning all of this was the idea that households, especially those in wealthy countries and enclaves around the world, could perpetually take on more debt because of sustained growth, asset appreciation, financial stability, low inflation and positive investment returns.

Nonetheless, the G20 has emerged as the successor to the G7/8 and a more credible forum for addressing the global economic crisis, and we need to see it as an important body in moving forwards to resolution and towards a new foundation for global economic coordination. For the latter effort, of course, the G20 has brought in heads of state and heads of government, and some beyond the normal G20 membership, and it seems sensible that this collective will need to be broadened further.

Certainly the G20 will need to make much faster progress in ensuring that our multilateral institutions more effectively raise the voice and participation of all members. A range of options are available for that, centred around reform of the governance and institutional makeup of these organisations, and involving adjustments to shareholdings and decision processes that reflect in a more balanced way the interacting interests of member states and their people. These actions should be grounded in a new compact with the developing world – on an agreed set of support mechanisms that add value to economic development – and a new compact with the developed world that emphasises mutual macroeconomic and financial dependence and the shared responsibility of the global community for our global endowment – the physical environment, human solidarity, accumulated knowledge and technology, shared transport, communications and energy resources and the institutions of social and economic cooperation that cut across national boundaries.

Measures to respond to the crisis

The fact of the matter is that global macroeconomic imbalances need to decline in size, and toxic assets need to be disposed of (written-off). The first requires a rise in saving in debtor countries and a decline in saving in creditor countries, and higher world interest rates for some years. The G20 has focused on:

- stabilising the global financial system,
- countering the economic downturn,
- ensuring resources and means of preventing a collapse in developing economies, and
- securing an open and fair trade and finance system for the long-term.

In the short-term, economic stabilisation is an obvious priority, while remaining perilously out of reach. Household saving has already risen in many countries and in due course household debt levels will retreat. But this will also lower consumer spending for an extended period of time, and therefore drag down economic growth in economies like the US, the UK and Europe. Consumer spending in those economies accounts for 40% of total economic activity in the world. As lower consumer spending feeds through into investment, medium term growth will also falter, and growth in economies with trade and financial ties with large advanced economies will also slow. We have seen this process in action over the past year or so as economic growth rates plunge around the world.

Declining debt levels for households and firms will emerge as the underlying dynamic driving the future economic recovery, but the pain experienced in the short-term is dramatic. Governments around the world have implemented fiscal measures to boost aggregate demand in the near term, in part to offset the general economic dislocation associated with the deleveraging. Monetary easing has in some countries been extensive, with historically low interest rates and quantitative easing in place in the US and the UK to try to get financial institutions

to extend credit to firms and households. In other countries, including our own, interest rates have begun to fall quite sharply.

By any fiscal or monetary measure, South Africa's macroeconomic response has been large. Our fiscal response as a ratio of the slowing in our gross domestic product has been larger than nearly all other countries, except for the United States.[2] On the monetary side, the interest rate has been cut by 250 basis points, ranking us in the middle of the G20 spectrum. Unlike in the US and the UK, we have plenty of room for further monetary easing, and as inflation continues to fall, so too will our interest rates.

But these sorts of macroeconomic offsets to falling demand are not a panacea, and will do little to stop the economic adjustment facing overly indebted households and firms. Our task in the short and medium term is to ensure that we minimise the damage to the rest of the economy from deflation in the over-indebted groups and sectors. Unfortunately, this is not a simple exercise, and many firms that have expanded in recent years will fall back to more sustainable levels of production and employment. Some sectors will need to shrink even further as they are more fundamentally uncompetitive. Governments here and abroad must address these challenges by ensuring that safety nets are in place and effective, that skills retraining works well and quickly, and that sectors of the economy not burdened by debt are able to grow and increase employment.

The adjustment of the South African economy to the crisis has been less severe than in many other countries. The exchange rate has depreciated significantly, by 27 percent in 2008, and it remains today 17 percent below the value pertaining in July 2008 at the height of the commodity boom. When the global economy begins to recover, a more competitive exchange rate should enhance foreign demand for our exports.

[2] We measure this as the change in fiscal balances over the period 2007 to 2010 divided by the change in the output gap over the same period. The output gap is measured as the difference between potential economic growth (non-inflationary) and actual growth rates. For South Africa, the output gap change is -4.1 percentage points and the fiscal shift is -3.9 percentage points. The ranking of size of change is: US, SA, UK, Canada, Germany, France, Japan, Italy.

At the same time, South African households have set the stage for a recovery in the medium term in consumption. Household debt levels have declined sharply, from about 78% of GDP to our estimate of nearer 70% today, which, along with declining debt service costs, will help to free up considerable purchasing power. This will be offset negatively by a lower value for financial and property assets which are unlikely to reach their mid-2008 highs in the next few years, and which impact on consumer spending.

Easing credit constraints in advanced economies is critical to reinvigorating economic growth. But a major part of the crisis has been caused by the uncertainty about the value of defaulting assets on the balance sheets of many financial institutions – the so-called toxic assets of collateralized debt obligations and somewhat more indirectly credit default swaps. These need to be addressed to enable banks to stop restricting credit, and are being tackled in different ways in affected economies, including the use of liquidity support, government guarantees, equity purchases, deposit insurance, and moving impaired assets to bad banks or making markets to realise prices for the assets.

Exiting the crisis and setting the ground for a renewal of macroeconomic and financial stability and sustained economic growth will depend on how countries address national and international financial regulatory concerns. As you all know by now, widespread failures have become evident in everything from mortgage lending practices to the failure to realise that off-balance sheet special purpose vehicles constitute major balance sheet risks. The world's financial intelligentsia clearly erred in judging an appropriate and sustainable balance between supporting financial innovation and feeding the credit default swap casino. I fundamentally disagree with the idea that we can get the former only if we allow the latter. We are in danger now of having both being shut down by populations angry at this folly.

Nevertheless, I believe the G20 has stepped out onto the right path by identifying a range of specific areas of financial regulation that need urgent attention. Many

more areas that need to be addressed will most assuredly be added by other observers and analysts.

The G20 has discussed the need to:

- Broaden effective regulation to all systemically important institutions,
- Ensure the registration and regulation of hedge funds,
- Call for registration and compliance with relevant codes of all Credit Rating Agencies whose ratings are used for regulatory purposes,
- Reinforce macro-prudential oversight,
- Enhance the counter-cyclical effects of financial regulation, and
- Strengthen international regulatory cooperation.

Addressing the financial aspects of the crisis is clearly necessary, and while we might agree on many of the reforms to regulations, regulators, and financial markets, we also need to remain mindful of the long-term implications of what we do. We need to remain cognisant of the gains that have accrued to marginalised communities from the extension of financial services in recent years.

I believe that it will be necessary in coming months to move to protect those achievements and the economic benefits associated with them. The Mzanzi accounts, and the services related to them, have helped bring poorer communities closer to the formal economy, over time helping to reduce recourse to loan sharks and ultimately strengthening information networks that are important to more distant needs, like searching for jobs. In short, I am concerned that we wander too far down the road of reaction to the financial markets by penalising those among us that have least access and need it the most.

Yet the global crisis is pulling down growth rates in the developing world, as trade finance dries up and capital flows back to originating countries generates

macroeconomic instability and reveals large financing gaps. The cost of capital for emerging markets which are able to borrow in international and sometimes their own domestic capital markets, has increased and remains high. The JP Morgan Emerging Market Bond Index has the average risk premium now at 633 basis points above the yield on US Treasuries.[3] This elevated cost of capital will remain a constraint on emerging markets and developing countries until the global crisis eases.

The Institute for International Finance expects private capital flows to the developing world in 2009 to fall to just US$165 billion, compared to the high of US$920 billion achieved in 2007. This is a serious decline, and risks putting the recent favourable performance of many economies at risk of reversal. The developing world has taken on a more important role in world economic growth, and in 2009 and 2010 provides some buoyancy to global growth rates.

The G20 has agreed to a significant increase in financing for the IMF – US$250 billion – and considerably more was discussed as an option. The multilateral development banks will be further supported too. These represent important additions to the capacity of our multilateral institutions to prevent crises in the developing world and foster economic growth and sustainable macroeconomic policies.

Declining commodity prices and failing capital flows need to be offset within the developing world by greater access to multilateral financial flows, and critically a renewed commitment to domestic policies focusing on human capital development, institution and capacity building, and of course macroeconomic stability. Reinforcing the good policy trajectory of the past 15 or more years is in many ways the only response that the developing world has in its own power to decide on and implement. It needs to do so. Africa has to build on the progress achieved in defining regional economic integration as the building block of a successful continental economy. Meaningful steps to lowering tariff and non-

[3] South Africa's EMBI figure is 442.

tariff barriers between African economies would provide impetus to economic growth without, in the current environment, presenting opportunity costs in the form of trade diversion.

So where does this leave us?

It is trite to observe that the global economic crisis will not disappear overnight. This is because the global macroeconomic imbalances of surplus countries feeding the insatiable appetites of deficit countries will not unwind quickly, especially for as long as we believe that it is the sole responsibility of the US to alter its policies to solve the immediate collapse in world aggregate demand. Yes, the US needs to act, and is doing so, but so too do countries with large current account surpluses and the rest of us. The unwinding of global imbalances depends on longer-term structural, regulatory and behavioural changes in many countries that will take time to achieve. In the meantime, macroeconomic volatility and international financial contagion emanating from advanced economies will present serious problems for the developing world.

There is a risk that global crisis will lead to national or regional inaction – I hope that I have made clear that I believe this is a time for renewed efforts towards accelerated economic integration in Africa and more broadly across the developing South. As trade and financial ties, many of timeworn provenance, disintegrate, new opportunities to forge more economically efficient relationships emerge. Trade between African countries seems a target worth examining in the interest of developing robust regional economic communities. Deeper integration and more rapid economic growth in Africa and the developing world generally carries with it extensive benefits for the world economy. Getting those regional policies right, however, requires us to focus ever more fervently on economic reform and institution building at home.

It is also important to examine in more detail what kind of economic adjustment is needed in conditions of declining foreign and domestic demand. While macroeconomic policy can, to some extent, help support demand, it cannot offset the decline on a one-for-one basis. This implies that demand for some sectors' output will fall, irrespective of government actions. The further implication is that firms will need to price to re-establish volumes of product sold or in demand. There are numerous examples of companies moving in that direction, including the recent announcements by ArcelorMittal South Africa and many retailers of significant price cuts.[4] Unfortunately, some other industries appear to believe they can adjust best by raising prices in an effort to maintain profit margins on a smaller volume of sales. This seems especially unhelpful in the current environment, and will be costly in terms of employment.

From the side of government, limited state resources should continue to be deployed in the pursuit of economy-wide measures that have as broad an economic impact across as wide a range of firms, sectors and workers as possible. This starts of course with a stable, low inflation fiscal and monetary environment. It includes vigorous enforcement of competition laws, continued improvements in our regulatory regime, streamlining of our tax and tariff systems and upgrading of basic transport, energy and telecoms infrastructures. Improvements in education and basic health delivery must remain at the heart of our efforts to improve both competitiveness and social justice.

These are, in my view, better uses of public resources than the frequent demand made for special assistance to specific firms and sectors. In the National Treasury we have come to recognise the importance of creating the fiscal space when revenues are strong to help offset the downturns. Extended to the private sector, it suggests that expectations that government will socialise the costs of

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[4] According to Engineering News, ArcelorMittal announced price cuts between 5 and 8% on steel orders from 1 April, on top of 40% declines since the middle of 2008. The World Steel Association said recently that capacity usage was around 50% to 60% currently, with global production down 24% in January. This is in contrast to auto manufacturers who are looking to raise prices this year by 20 to 30%.

irrational exuberance cannot be entertained. This is neither good for long term growth nor is it what is required to deal with our shorter term difficulties. A vigorous and competitive private sector is essential to our long-term economic development, backed up by an effective and capable public sector.

Allow me to conclude by making a few points about our multilateral system. A sustainable recovery for the global economy in my view requires a more balanced and inclusive governance structure for the world economy. Achieving that has proven rather difficult, largely because too much of the developed world and too much of the emerging world find it expedient to cling to the vestiges of power conferred on them (or held out to them) by our multilateral system. But we need to stand back and ask what the point of that jealousy really is. If we buy into the view that economics is a positive sum game, then our institutions should have as their central themes transparency, inclusion, and agreed rules. I fear that our historical legacy of nationalism and the national exercise of power continues to betray our global interest in a more inclusive system, and that this will have the effect of delaying our exit from the present economic crisis.

We can respond to this problem in several ways. One is to vigorously pursue regional economic integration – creating cross-border infrastructure, making better use of the multilaterals that we have agreed to strengthen, becoming bolder in our drives to reform and deliver. A second is to work much harder to ensure that we are delivering effective public services. A third is to place employment, productivity and competitiveness at the heart of our approach to trade and industrial policy and sector regulation. A fourth is to maintain our counter-cyclical, low inflation and prudent approach to macroeconomic policy. Finally, we must continue to define and give expression to the need for an inclusive and fair global economic system.

Thank you.