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REVISITING OUR ECONOMIC FORECAST IN VIEW OF THE GLOBAL FINANCIAL MELTDOWN

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Introduction: identifying the local impact channels

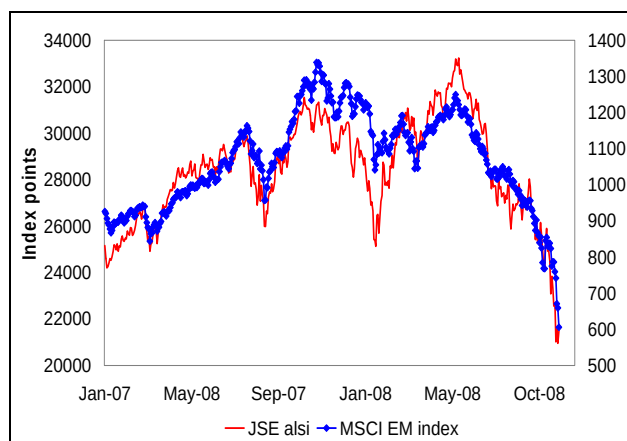
The extraordinary (and ongoing) events on the major financial markets have driven one certainty home. This is the fact (now) that the (global) real economic consequences flowing from the US-born sub-prime mortgage crisis, which burst into full force almost 15 months ago, will be painful. The global economy is entering a recession – all that remains unclear is how deep and protracted this recession will be. The IMF revised its forecast for global real GDP growth down to 3% in 2009 (from 3.9% in its July 2008 *World Economic Outlook Update*; in 2007 global growth came in at 5%), but even this substantial downward revision may prove optimistic.

The financial crisis has developed into a full-blown credit crunch where it is not only the interbank money markets that have seized up, but also the commercial paper market, which is affecting the working capital and capital spending needs of private sector companies. Some banks have experienced runs from depositors. The scale of official intervention to counter these disintermediation tendencies is comparable to that of the 1930's depression. The worrying fact is that these interventions, including the unprecedented co-ordinated monetary easing by six of the world's major central banks two days ago have to date not restored a semblance of confidence in the financial markets. In a recent report, the IMF warns that: "... the risk of a more severe adverse feedback loop between the financial system and the broader economy represents a critical threat." (*Global Financial Stability Report, October 2008*).

The distress on financial institutions' balance sheets constrains credit intermediation, slowing down economic growth, which in turn leads to further credit deterioration. Current IMF projections are for credit growth in the United States, the Euro area and the United Kingdom to slow to near zero over the next year before picking up again in 2010.

The IMF is unambiguous in describing the financial crisis as a systemic one and continues to upscale the estimated financial losses linked to the US sub-prime fallout¹. We already know that the global downturn underway will be worse than the brief recession experienced in 2001/2. The question is whether it will equal the severity of the early 1990's recession (when regional disparities contained the global dimension), or even surpass that to make it more comparable with the last major global economic downturn experienced in the early 1980s. Typically in the past – the IMF reminds us – when a banking crisis is part of the meltdown, the contraction in economic activity is deeper and the road to recovery slower and longer. The current financial/ banking crisis clearly has medium-term implications. This by way of background; *how do we see the SA economy impacted on the basis of what we know now?*

Figure 1: Emerging market equities suffer



Source: Reuters

¹ See IMF: *A Systemic Crisis Demands Systemic Solutions*, 22 September 2008. The IMF's latest estimate is for losses on U.S.-based loans and securities to rise to \$1.4 trillion (*Global Financial Stability Report, October 2008*) – a significant increase from the estimate of \$945 billion in April 2008. It is estimated that roughly \$560 billion of the losses had already been realized through end-September 2008; however, bank share prices continue to plummet and revenue prospects have stalled, presenting challenges for banks to re-capitalise.

While SA's direct exposure to the sub-prime crisis may be negligible, the country is unlikely to escape the indirect impacts. Even the banking sector may suffer indirect impacts via third party exposures; however, it has to be said forthwith that the scale of local uncertainty is most unlikely to acquire the proportions which typically cause a run on any bank (*à la* Saambou in 2002). SA's banks are well capitalised and well-positioned to navigate the local economic downturn underway.

The more significant impact channels are likely to be: *firstly*, pressure on the rand exchange rate due to balance of payments pressures – the more severe the pressure on the balance of payments resulting from capital outflows, the sharper the pressure on the rand exchange rate, inflation and interest rates. The balance of payments risk is heightened due to a likely deterioration in the current account deficit (before it improves as domestic demand and imports fall away) due to weaker commodity prices and demand for exports over the near term. The weaker rand exchange rate will put pressure on inflation and interest rates, which may stall an (otherwise desired) easing of monetary policy under the current conditions. The sad reality for South Africa is that, faced with a large foreign financing requirement, macro policies need to be tightened in the event of sustained capital outflows; alternatively, in a more benign outcome it may limit the scope to ease monetary policy over the near term. *Each of these impact channels are unpacked below.*

The aim of the present note is to provide some comment on the current global financial meltdown, the associated global economic downturn and the likely impacts on the local economy. The economic forecasts provided here cannot fully discount the possible impacts given the extreme financial destruction and volatility of the moment. The risks highlighted throughout the note are as important as the numbers, if not more so. We hope to provide a fuller and more detailed picture in our forthcoming Economic Prospects (4th Quarter 2008) report planned for release later this month.

Table 1: Revised world economic outlook – real GDP growth

	2007	2008	2009		2006	2007	2008
Industrial countries				Developing countries			
Advanced economies	2.6	1.5	0.5	Emerging Asia ²	5.7	4.5	3.8
USA	2.0	1.6	0.1	China	11.9	9.7	9.3
Japan	2.1	0.7	0.5	India	9.3	7.9	6.9
Euroland ¹	2.6	1.3	0.2	Latin America	5.6	4.6	3.1
Germany	2.5	1.0	0.0	Emerging Europe ³	6.3	5.0	3.5
UK	3.0	1.0	-0.1	Sub-Saharan Africa	6.9	6.1	6.3

¹ The 12 Euro countries; ² Taiwan, Hong Kong SAR, Singapore, South Korea, Malaysia, Indonesia, Thailand and Philippines;

³ Central & Eastern Europe (excluding Turkey)

Source: IMF *World Economic Outlook*, October 2008

SA's balance of payments vulnerability spells rand exchange rate risk

In the current global financial environment where banks have stopped lending to each other, stock market traders are running thin on basic trust, international investors withdraw from (perceived) risky markets along with corporates repatriating capital in order to repair balance sheets, SA's relatively large current account deficit is very uncomfortable. Add to this the fact that it is likely to deteriorate before it improves due to the decline in export demand and commodity prices, the risk of sharp rand exchange rate depreciation is high as developments over the past week have demonstrated. *The BER's view on SA's current account deficit can be summarised as follows:*

- While we expect a deterioration on the overall balance of payments (both on the trade and capital accounts), putting pressure on the rand exchange rate, we think the malaise may be contained. We have raised our current account deficit forecast for 2008/9 (to 7-7½% of GDP) and factored in a sharper (but still contained) rand exchange rate depreciation. Commodity prices (a basket of industrial raw materials) are projected to fall by 20% on average next year, with the peak having been established during the second quarter of 2008.
- While the commodity price correction underway will exert pressure on the trade account of the balance of payments and the rand exchange rate over the short term, there are countervailing factors. In the short term, the gold price is proving more resilient due to gold's safe-haven quality in these uncertain

times. SA's other key primary exports such as coal and iron & steel may also be more resilient with prices falling with a lag. The bulk of SA's primary exports (around 55-60% of total export earnings when base metals are included) are destined for Asia, which absorbs around one third of SA's total exports. The medium-term prospects for China and the emerging economies remain positive – emerging economies are likely to weather the current storms in better shape (as they are the saving surplus countries) and their industrialisation drives will not be suspended. Once investors navigate beyond the current financial instability this reality will move to the forefront again. Developing economies with an exposure to commodities stand to benefit, both on their trade accounts (exports) and financial accounts (equity investment in the resources sector). This factor should counter full-scale malaise on the SA balance of payments (other things being equal). The implication may also be that rand weakness may be followed by recovery. However, it has to be pointed out that substantial risk prevails in the current highly unstable financial environment.

- SA's vulnerability is bigger in terms of export exposure to the US (15%) and European markets (33%). In this regard the sharp contraction in economic activity projected for these regions during the second half of 2008 and the early part of next year comes at a very inopportune time for SA's exports, particularly in respect of manufactures (*see Table 1 for the latest IMF forecast for global real GDP growth, 2008/9*). The second quarter trade data reveals pockets of strength in manufacturing exports (food, chemicals, plastics and autos) and the BER's Q3 business survey in the sector shows a pronounced relative improvement in actual export sales and export expectations. The stabilisation of the Investec PMI in August and September (contrary to the sharp declines in the USA and European PMI counterparts), combined with improved 6-month expectations were encouraging. However, it is clear that these positive tendencies will be under threat in the coming months given the evolving recessions in the advanced economies where much of SA's manufacturing exports are destined. Excluding base metals, the manufacturing sector accounts for around 35% of SA's total export earnings.
- Regarding the capital account of the balance of payments, developments during 2008 are of concern. The net inflow of portfolio investment during 2006/7 (exceeding R200 billion), financing more than 60% of the cumulative current account deficit over this period, has reversed into an estimated cumulative net outflow approaching R20 billion during the first three quarters of 2008. While there have been counter capital inflows as overall foreign exchange reserves only declined marginally in August and September (\$600 million), the pressure on the exchange rate during the past week suggests a further deterioration. On the positive side, SA's external debt to GDP ratio stands at 26.6% (end-2007), which is low by international standards. Should the rand come under more severe pressure, the conversion risk on corporate balance sheets will be contained. As noted, SA's commodity exposure will also support capital inflows beyond the current financial volatility and extreme investor risk aversion.

The net outcome of this is likely to be a weaker rand exchange rate. The US dollar has tended to strengthen due to its international reserve currency status and as US investors and corporates move capital back home in support of their deteriorating balance sheets. The yen has also strengthened substantially, while the Euro has weakened. This was to be expected as the Euro has absorbed most of the US dollar's weakness in recent years, but also due to the fact that the European linkages with the US sub-prime fallout have become more exposed in recent weeks in what can be described as a 'second phase' of the sub-prime credit crisis.

It is difficult to call the outcome for the dollar/euro exchange rate. The assumption we adopted is consistent with recent tendencies which showed a strengthening of the US dollar, which may persist through end-2009. This tendency may be derailed in a scenario where European intervention to stabilise the financial crisis at home proves more successful compared to failure in the US to do this. At the time of writing, the sustained and vicious stock market declines across the Atlantic spell heightened uncertainty benefiting the dollar and the yen.

On this basis the rand may depreciate more sharply against the US dollar over the near term and the yen compared to that against the euro. However, accepting fundamentally more rand weakness, it is to be expected that the rand will also depreciate against the euro as happened in the recent past. To date the rand exchange rate is down 20% this year (on a trade-weighted basis; and 35% down since its peak in April 2006). Our current call on the rand exchange rate outlook is shown in *Table 2*. This is a downward revision from our previous below-consensus forecast, but we would still describe it as a relatively contained move provided the tumultuous global financial developments and SA's current account deficit exposure.

Real economy outlook on baseline assumptions

Considering the 08Q2 GDP figures, it is evident that the SA economy has slowed down substantially since the middle quarters of last year. Distortions in the quarterly growth pattern tend to disguise this underlying trend (labour strikes in key industries during 07Q3 and subsequent recovery in manufacturing value-added; the electricity blackouts and mining shutdowns during 08Q1 and the subsequent recovery). It is therefore useful to

consider real GDP growth (q/q, annualised) excluding mining and manufacturing, which reveals a slowdown in the underlying growth momentum from 6.4% (07Q3) to 2.5% (08Q2); if the boost from agriculture is excluded, the underlying growth momentum is closer to 2% during the second quarter. Given the further declines in business confidence during the third quarter of 2008, we expect this growth momentum to slow to 1.5% in Q3 and possibly below 1% in Q4 and early next year. While we have factored in the projected contractions in G7 countries real GDP over the current and coming quarters (*Table 1*) and the associated commodity price declines, the real economic repercussions from the ongoing financial shocks remain highly uncertain. *On baseline assumptions, real GDP is forecast to come in at 3.4% this year and to slow further to 2.2% next year.* This is a downward revision of our July forecast of 3% growth in 2009. The key change resides in the export outlook.

Assuming that the rand's depreciation does not become disorderly, we continue to factor in interest rate cuts, the timing of which will – again – be dependent on the course of the rand exchange rate. On baseline assumptions, CPI inflation is forecast to decelerate from a peak of 13.7% in August 2008 to 7.5% on average during 2009. A lower oil price (we have revised our assumption here to \$80 and \$85 on average during 2009/10 respectively) will be countered by the weaker rand exchange rate, which has a more permeating influence on broader inflation compared to oil. In fact, the revised oil price/ exchange rate assumption adds close to 70 c/l to the local petrol price (by end-2010) compared to our earlier assumptions (oil at \$98 and R9/\$). It is likely that global inflation will surprise on the downside given the widening output gaps developing, not only in the advanced economies, but also in the emerging economies and the projected declines in key commodity prices. Should the rand prove more stable compared to our current assumptions, domestic inflation outcomes are also likely to be lower than we currently project. *The SARB revised its forecast for consumer inflation to 6.9% on average during 2009 in yesterday's MPC statement.*

The SARB's October 2008 monetary policy statement can best be described as neutral, leaving both questions, i.e. *have interest rates peaked*; and, if not, *when can the first easing be expected*, unanswered. *The BER's baseline assumption remains for the next move to be down, with a cumulative 200 bps cut in the repo rate commencing during the second quarter of 2009.*

This interest rate pattern combining with boosts to real purchasing power on the back of decelerating inflation should induce some recovery in household spending and private fixed investment during the second half of 2009 and into 2010. These two categories of domestic spending are forecast to come under substantial pressure over the near term and towards the middle of the year. As we were already more bearish compared to consensus in this regard in our previous forecast, we have not made substantial downward revisions in our real GDE growth projections. The more significant downward revision is on the export side given the onset of a likely global recession. The BER's model simulations and analysis shows that SA may still escape a recession (in the technical sense of the word); however, any further interest rate hikes due to balance of payments problems could change this outlook.

Recession, or not, it has to be accepted at this point that real economic conditions will be very challenging over the short term. Debt consolidation, belt-tightening and cost-cutting are likely to be the operative behaviour in the private sector; households are also likely to contain and cut back spending and improve personal savings (in this regard the -0.6% of household disposable income personal savings ratio in 2008H1 is somewhat unnerving). Broader economic activity has already decelerated from an exceptionally buoyant period (2004-7), which has induced substantial adjustment in the household and business sectors, best reflected in the sharp declines in business and consumer confidence during 2008. The repeated shocks during the course of 2008 have added insult to injury.

As noted, the constrained manufacturing export performance and the deteriorating global demand conditions limit the extent to which an improvement in net exports (i.e. export growth minus import growth) can counter the substantial slowdown in the domestic market (*projected at 2.6% real growth in 2009, down from 3.7% in 2008 and 6% in 2007*). Nonetheless, one should expect that the combination of lower real domestic expenditure and a weaker currency will reduce import demand and in this way support overall real GDP growth (*3.4% and 2.2%, 2008/9 respectively*) and steer the economy clear of a recession proper. Import replacement should benefit the goods producing sectors of the economy.

Concluding remarks on extraordinary times

It goes without saying that the extreme volatility of the moment makes nonsense of any numeric forecasts at this stage. In this light forecasts, which remain necessary for planning purposes, have to be understood as open-ended where the highlighted risks become as important as the numbers. Nonetheless, the broad picture presented here hopefully provides some basis conducive to planning in highly uncertain times.

The broad picture at this point amounts to: a global recession of which the recovery is likely to be slow and tedious, with real economic growth in the advanced economies coming in below trend for the next 2-3 years. The re-engineering of the international financial architecture and the deleveraging occurring in a range of developed economies will tend to suppress credit growth and real economic activity for the foreseeable future. Locally, this will exert a negative impact on economic growth. Over the near-term, the adverse real economic impact may be more severe while balance of payments risk will be paramount; however, SA's low direct exposure to the credit crises and its low foreign debt exposure suggest some insulation to the global economic downturn. On the policy front, SA is fortunate to have substantial ammunition in both the fiscal and monetary policy departments to counter recessionary economic conditions provided the balance of payments holds. Beyond the financial turmoil of the moment, and expected to persist (in some destabilising way) over the next 3-6 months, SA's commodity exposure to the rapidly industrialising emerging economies, the public sector fixed investment drive and hopefully an improved export drive in response to a more subdued domestic market and a more competitive rand exchange rate should support the balance of payments and overall real economic growth.

The biggest risk to this domestic outlook would be interest rate hikes on the back of undue balance of payments pressures leading to a destabilising depreciation of the rand exchange rate. In this respect it is to be hoped that prudent macro-economic policies will not be replaced by populist alternatives and that the growing turmoil in the governing ANC alliance does not deliver additional shocks.

Table 2 contains the BER's provisionally revised headline forecasts; final revisions will follow in our Economic Prospects, 4th Quarter 2008 report to be released later this month. Also visit our website: www.ber.ac.za for more detailed updated forecasts.

Table 2: Preliminary BER forecast of key economic variables: 2008/10

SA economy: October 2008 (preliminary forecast)	2007	2008F	2009F	2010F
Real GDP growth	5.1	3.4	2.2	4.1
Real HCE growth	7.0	2.6	2.0	4.3
Real GC growth	5.0	4.7	4.3	4.2
Real GDFI growth	14.8	10.5	2.9	6.1
Real GDE growth	6.0	3.7	2.6	5.1
Real export growth	8.3	1.6	1.4	4.6
Total employment growth	2.7	1.7	0.9	2.0
Target inflation	6.5	11.5	7.5	5.8
PPI inflation	10.0	15.9	9.7	6.4
Prime interest rate (eop)	14.50	15.50	13.50	13.00
R157 bond yield (eop)	8.44	8.96	8.50	8.60
R/\$ exchange rate (Q4)	6.77	8.46	9.55	10.12
R/€ exchange rate (Q4)	9.81	11.85	13.02	13.25

HCE: Household Consumption Expenditure; **GDFI:** Gross Domestic Fixed Investment; **GC:** Government Consumption

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