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BUREAU FOR ECONOMIC RESEARCH *BER comment: European debt problems*

SA VULNERABLE IF THE PIIGS PROBLEMS ARE NOT CONTAINED

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Introduction

While the most severe global recession since the Second World War ended some time ago - the IMF reports that the global economy grew by 4.5% in the second half of 2009 - the fallout from the crisis continues to (periodically) haunt global financial markets. The latest source of concern is heavily indebted (mainly Southern, although not exclusively) European countries, most notably Greece.

Although the analyst community and financial markets have been worried about Greece's high debt levels¹ for some time, the negative sentiment worsened dramatically on April 27 when the rating agency Standard & Poor's (S&P) downgraded the country's credit rating from BBB+ (same as SA) to BB+, i.e. below investment grade. Equally negative was S&P's estimate that in the event of Greece defaulting on its debt payments, investors would receive only 30% of the amount they invested in Greek bonds.

The fear of default / debt rescheduling, or at least serious fiscal problems in future, has spread to other indebted European countries such as Portugal, Italy, Ireland and Spain (along with Greece dubbed the PIIGS)². Given the much larger size of its economy, of more importance is that the UK – with an expected 2010 budget deficit of more than 11% of GDP – is increasingly also being bracketed along with the PIIGS as having the potential of running into funding difficulties. Furthermore, because European banks are by far the largest holders of PIIGS debt (exposure estimated to be a massive \$3.1 trillion), the fiscal difficulties raised concerns about the stability of the wider European financial system. Given that Europe is (after Asia) SA's largest export destination, contagion from the Greek crisis may also have adverse consequences for the local economy.

After doubting that an already increased €110bn Greek aid package would be sufficient to alleviate the country's woes, the European debt fears were temporarily eased when the EU, along with the IMF, announced a huge €750bn (close to \$1 trillion) European Financial Stabilisation Mechanism to provide financial assistance to member states in need. Crucially, in order to access the funds, countries facing difficulties must show a commitment to strict fiscal austerity measures.

¹ At an estimated 13.6% of GDP for 2009, the country has the second largest fiscal deficit in the European Union after Ireland. Consolidated government debt is estimated at 115.1% of GDP for 2009, by far the highest of any of the 16 countries using the Euro.

² Indeed, since June 2009 Ireland, Portugal and Spain have all seen their credit ratings downgraded, albeit that they continue to be rated A or higher by S&P, i.e. above SA.



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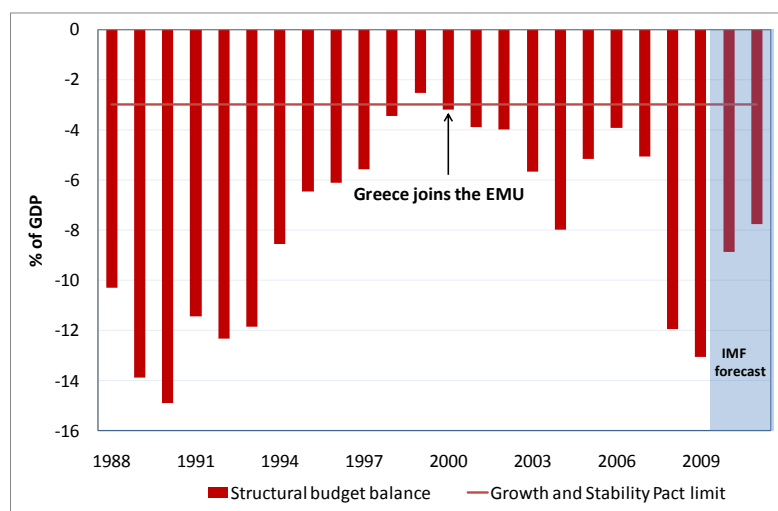
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This note aims to gauge the likely impact that the European problems could have on the SA economy. After providing a brief background to the Greek drama, the note analyses the channels through which the current problems could influence the local economy. The final section concludes.

Background – EMU benefits and pro-cyclical Greek fiscal policy resulted in overspending

Greece became the 12th member of the European Monetary Union (EMU)³ in 2000. Figure 1 indicates that the country made big strides to reduce its structural⁴ budget deficit to within the 3% budget deficit limit set out in the Growth and Stability Pact⁵ in the years before it joined the Euro. However, the graph also highlights that the substantial gains made in consolidating the fiscal position were short lived following entry into the EMU. Indeed, ever since joining the Union, Greece has failed to comply with the EMU budget rules.

Figure 1: Greek fiscal position deteriorated after euro-entry



Source: IMF

An interesting comparison between the Greek crisis and the bursting of, for example, the US housing bubble concerns the impact of an overly accommodative monetary policy. Commentators such as Stanford economics professor John Taylor⁶ have argued that a too easy US interest rate policy from 2002 to 2006 helped to fuel the US housing bubble and its subsequent burst. It turns out that low interest rates can also help to explain the current Greek problem, although it is by no means the only factor. Table 1 on the next page compares the level of real interest rates in the initial 11 EMU

³ The EMU, which consists of the 16 countries that currently use the Euro, should be distinguished from the larger European Union (EU). Besides the 16 EMU countries, the EU has 11 further member states, including the UK.

⁴ The structural budget balance represents what government revenue and expenditure would be if GDP growth was at its potential.

⁵ Recent revelations of gross misreporting of Greek fiscal data for 2008 and 2009 put a question mark on whether indeed the fall in the budget shortfall was as impressive as the official numbers showed.

⁶ See, for example, Taylor, J.B. (2007): Housing and Monetary Policy.



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countries as well as Greece in the years leading up to the formation of the EMU and also the subsequent years.

Especially for the periphery (PIIGS) countries, the introduction of the Euro brought about large interest rate declines (almost 3 percentage points on average for the EMU). Greece, in particular, benefitted significantly with the real interest rate averaging more than 6 percentage points lower in the six years after the EMU than before. The access to lower-cost credit boosted domestic demand with GDP growth averaging 4% between 2000 and 2008.

Table 1: Real interest rates before and after the formation of the EMU

	1993-98	99-2004	Change
Austria	2.5	1.2	-1.2
Belgium	3.1	1.2	-1.9
France	3.9	1.4	-2.4
Germany	2.5	1.7	-0.8
Italy	4.9	0.8	-4.1
Luxembourg	3.1	0.9	-2.2
Netherlands	2.1	0.7	-1.4
Finland	3.7	1.6	-2.1
Greece	7.4	1.0	-6.4
Ireland	4.5	-0.6	-5.1
Portugal	4.7	0.2	-4.5
Spain	4.3	0.0	-4.3
Average	3.6	0.8	-2.7

Source: Philip R. Lane, Trinity College Dublin

Because the periphery (or Southern European) countries experienced larger interest rate declines, property and stock market prices rose more sharply than in Northern countries. This in turn led to extensive borrowing and large amounts of foreign capital inflows. The high GDP growth rates caused Southern European wages to rise faster than in other parts of Europe, undermining competitiveness. With borrowing continuing to expand, the problems were hidden, but the credit crunch exposed the underlying structural weaknesses in many of the EMU countries. For example, Greece (on average) ran a current account deficit that measured 9% of GDP between 2000 and 2008.

A crucial contributing factor to the Greek woes was that the government fuelled the spending spree by implementing pro-cyclical fiscal policies, including tax cuts and higher spending on wages and entitlements (pensions and health care). As a result, the primary (excluding interest cost) budget balance deteriorated by 7 percentage points of GDP between 2000 and 2008. Hit by the global recession, Greek output declined by 2% during 2009. Combined with election-driven spending and overall weak expenditure control, the fiscal deficit surged to more than 13% of GDP, reducing Greece's ability to fund its shortfalls in the financial markets and raising concern that the country would be unable to meet its debt obligations.



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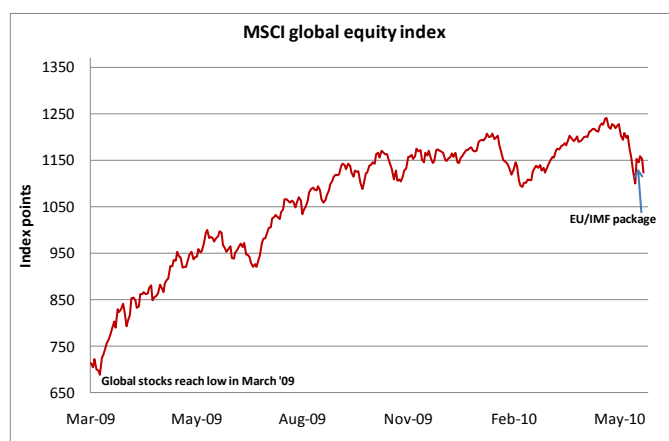
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Severe austerity measures will result in sharp output decline

The EU/IMF support provided to Greece (and other European countries in need) is conditional on the implementation of credible measures to rein in large budget deficits and reduce overall government debt over time. In reaction, Greece has announced unprecedented measures amounting to 11% of GDP between 2010 and 2013, which is expected to reduce the budget deficit from 13.6% of GDP in 2009 to below 3% during 2014. The austerity package contains both expenditure cuts and tax increases. The tax proposals include a rise in the standard value added tax rate from 21 to 23%, increasing excise tax on fuel, cigarettes and tobacco as well as a number of other measures, including higher assessments on real estate. The major expenditure cuts have been well documented and include increasing the normal retirement age in line with life expectancy, a cut in public sector wages, reductions in discretionary and low priority investment spending etc. A number of other countries, including Portugal, Spain and even the UK have followed Greece in announcing austerity measures in order to prevent a repeat of the Greek crisis.

A crucial question in the Greek saga is whether the government will be able to follow through on its austerity pledges amid widespread public discontent. Even after the EU/IMF package was announced, global financial markets have remained jittery (figure 2), suggesting that the government lacks credibility in the financial markets. Greece's fiscal history illustrates that the markets may be correct in doubting the government's resolve. The country has restated its budget deficit in each of the last 10 years. Even more concerning is research done by Prof. Carmen Reinhart and Kenneth Rogoff⁷, which shows that since the year 1800, Greece has spent more than half the years in default. Equally concerning, albeit not as bad, is that the figure for Spain is 23.7%. However, if one considers the number of times that Spain has defaulted since 1800, it is a lot worse (13) than in the case of Greece (5). Furthermore, the Argentinean experience⁸ of the early 2000s, for example, illustrates that governments are sometimes unwilling to enact the strict conditions attached to IMF lending.

Figure 2: Global equities remain under selling pressure



Source: Reuters

⁷ Reinhart, M.C. and K.S. Rogoff (2008): This time is different: A Panoramic View of Eight Centuries of Financial Crises.

⁸ Facing recession and a growing debt burden, the Kircher government rejected IMF advice to bring down government spending, forcing the IMF to pull its assistance in 2001. The largest sovereign debt default (\$81 billion) followed during 2002.

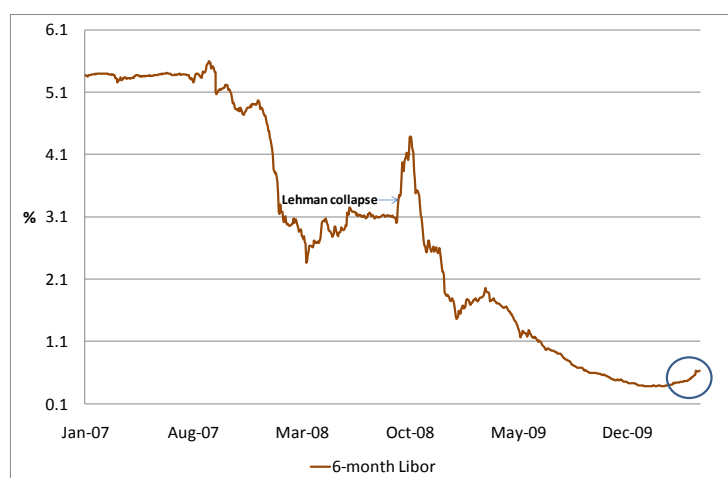


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A Greek default / debt rescheduling will no doubt result in renewed global risk aversion and will be a significant blow to the fragile global economic recovery. Under such a scenario, because European banks are heavily exposed to Greek debt, the euro zone will be hardest hit. Concerns about European bank exposure to PIIGS debt is already pushing up risk aversion in money markets – the London inter-bank offer rate (Libor) has risen to the highest level since August 2009 (figure 3), albeit still remaining at very low levels historically.

Figure 3: Inter-bank lending rates starting to tick higher



Source: Reuters

Even a scenario where Greece honours its commitments has negative (short-term) implications, albeit that the longer-term view is more optimistic. According to estimates from the IMF and Greek government, the fiscal measures will result in a real output decline of 4% and 2.6% during 2010 and 2011. Nominal GDP will also decline, meaning that the austerity plans will initially push Greece's debt to GDP ratio even higher. Fiscal consolidation in the other PIIGS countries will also constrain their output recoveries – the IMF⁹ also forecasts real GDP contractions in Ireland and Spain during 2010, while Italy and Portugal are set to grow by less than 1%.

Domestic impact - SA vulnerable to environment of increased risk

The May 13 statement that accompanied the SA Reserve Bank's decision to keep the repo rate unchanged at 6.5% highlighted domestic policy makers' concerns about the European debt problems.

In the second paragraph, the MPC statement says that: "The uncertainty related to the sustainability of fiscal deficits in a number of euro area countries, and the reaction of the financial markets to these events, has renewed fears of possible contagion which could affect the tentative recovery that has been taking place in most regions, including in South Africa. The concerted efforts by European

⁹ IMF World Economic Outlook, April 2010. It is important to remember that the IMF's forecast was done before the most recent fiscal announcements in countries such as Spain and Portugal. Furthermore, the UK's new coalition government is set to present an emergency budget in the next 50 days or so that may also contain fiscal consolidation measures that will constrain the country's GDP growth recovery. The Conservative party's election manifesto proposed spending cuts worth £6bn.



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governments, the European Central Bank (ECB) and the IMF have had some effect on calming the markets. However, significant risks to the global and domestic recovery remain.”

The immediate impact of the worsening Greek situation was felt on SA financial markets in the week before the large EU/IMF package was announced. Table 2 summarizes the movement of key local financial market variables between 30 April and 7 May 2010. It is clear that the only benefit SA received was from a higher gold price, which has remained firm in recent days – the other key variables all saw steep losses. Exporters may also have cheered the weaker rand, which at one stage in early May fell to a low of R7.94/\$. However, the losses were fairly short-lived with the currency recouping a large part of the losses against the US dollar and strengthening strongly versus the € in recent days (more on this below).

Due to SA’s well developed and liquid financial markets, as well as the country’s status as an emerging market running a current account deficit, local assets are prone to sudden and steep declines during times of increased investor risk aversion. Given that the current account shortfall is mainly financed by portfolio capital (“hot money”) flows that can easily be withdrawn again, the rand is particularly vulnerable during times of heightened risk aversion.

Table 2: Domestic markets fell sharply as Greek woes intensified

Variable	30 Apr	07 May	Change
<i>Currencies</i>			
\$/Rand	7.34	7.60	↓3.54%
€/Rand	9.79	9.82	↓0.31%
<i>Commodities</i>			
Gold (\$/oz)	1178.25	1207.75	↑2.50%
<i>Equities</i>			
JSE: Alsi	28,635	26,515	↓7.40%
<i>RSA Bonds</i>			
R204	8.47%	8.93%	+46bps
R157	7.79%	8.27%	+48bps

Source: Reuters

1.) SA has limited export exposure to the PIIGS; greater Europe remains important

Table 3 shows the value of SA exports to the most important geographic regions as classified by the SA Revenue Services. The good news is that the PIIGS, and Greece in particular, are relatively small markets for SA goods with the latter only responsible for 0.1% of total SA exports during 2009. The projected steep Greek output decline will have a minimal, if any, **direct** bearing on overall SA exports. Furthermore, domestic banks have been quick to reassure investors that they have limited exposure to PIIGS debt.

However, as mentioned earlier, European banks have by far the largest exposure to PIIGS debt. A default by one of the peripheral countries could have a significant negative impact of European



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financial stability and in the end derail the fragile GDP growth recovery in the region. The recovery will be hurt further if the PIIGS problems weigh on intra EU trade.

Table 3: Europe remains a dominant SA export destination (2009)

	Export value (Rbn)	% of total
Africa	89.3	19.7
Europe	147.5	32.5
of which to EU	121.9	26.8
PIIGS	21.1	4.7
Greece	0.4	0.1
America	51.2	11.3
Asia	159.2	35.0
Oceania	7.2	1.6
Total	454.4	100

Source: Calculated from SA Customs data

Even before the further deterioration of the Greek situation in early May, the IMF forecast in its April World Economic Outlook that the growth recovery in Europe would lag the rebound in countries such as the US and even Japan. Whereas EU GDP growth is forecast to average 1.25% in 2010 and 2011, at 2.85% and 1.95% respectively, the projections for the US and Japan are a lot better. The IMF argues that besides the large fiscal (the focus of this note) and current account imbalances in several euro-area countries, unresolved problems in the banking sector and vulnerable household and corporate balance sheets have limited the recovery in the hardest hit emerging European countries. On a more positive note, the recent Euro weakness should boost the growth recovery in the less indebted European countries such as Germany.

With the greater Europe responsible for a third of SA's export value in 2009, financial sector contagion in Europe, if Greece were to default, could have a dampening impact on SA's overall export performance. This would be particularly detrimental at a time when China, SA's largest export market in 2009, is implementing measures to cool down its rampant economy.

The domestic export difficulties will be worsened if the recent trend on global currency markets continues, i.e. a weaker Euro versus the US dollar, which has resulted in strong rand gains versus the single unit (figure 4 on the next page). After still trading above \$1.50 at the end of November 2009, the Euro has declined by almost 19% versus the US dollar to a four-year low around \$1.23 amid the European sovereign fears. During the same period, the rand has gained more than 16% against the single currency.

Looking forward, even if the Euro started to gain ground versus the dollar once again, the wider implications of the European problems (most importantly weaker growth) may be rand positive if, for example, it results in major central banks such as the US Federal Reserve being more cautious before starting to raise interest rates from the current record lows. A recent *Wall Street Journal* survey revealed that as a result of the European turmoil, investors and economists are pushing back the expected date of the first US interest rate hike. The survey found that 42% of respondents now expect the Fed to hold off on tightening credit until 2011 or beyond. A month earlier, only 28%



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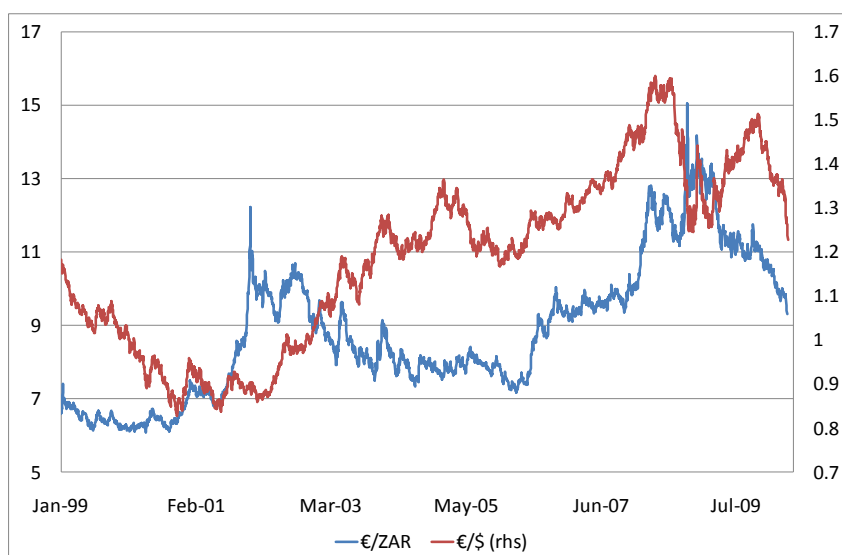
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thought the US central bank would wait until then. As long as US (and other major central bank) rates remain at current lows, it should attract investors looking for superior returns to higher yielding emerging markets. So-called carry trade flows may continue to benefit the rand.

On the other hand, a further unraveling of the Greek et al crisis will lead to increased investor risk aversion, which is more than likely to result in foreign investors liquidating their portfolio investments in countries such as SA, with a weaker rand (especially versus the US dollar) the most likely scenario. As a result of SA's superior fiscal outlook (government debt is set to increase to "only" around 40% of GDP in the 2012/13 fiscal year versus above 100% in many advanced economies), it could be argued that the savvy investor may actually favour investing in SA bonds even if risk aversion sours, but recent history suggests that investors sell-off perceived riskier assets indiscriminately during periods of increased market jitters. *The confidence shock and negative consumer wealth effects brought about by declining stock prices on the JSE could delay the projected recovery in SA consumer spending, especially on durable goods.*

In terms of commodities: While the gold price should gain further ground in such a scenario, other mineral prices that are more important to SA exports (platinum and iron ore) may suffer in an environment characterized by renewed global growth concerns. The CRB commodities index, which tracks the movement of 19 commodity prices, is down by more than 12% so far in 2010. On a positive note, the oil price should also be lower than assumed if global growth relapses with positive domestic inflation implications.

Figure 4: Euro weakness fuelling rand strength



Source: Reuters

Everything considered, at this stage it is probably reasonable to remain with our forecast that the rand will average R7.85 versus the US dollar during 2010Q4. Given the risks (outlined above) that Greece may default on its debt, for the foreseeable future the risk remains that the rand could depreciate faster than generally expected (against the US dollar). With the Euro having weakened by significantly



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more than previously thought versus the dollar, our rand/euro forecast for an average of R10.68/€ in the final quarter of 2010 now looks unlikely with the local currency set to end the year below R10/€.

2.) Monetary rather than fiscal policy reaction likely in the event of an European growth relapse

Given the global focus on fiscal sustainability and the fact that SA government debt is set to rise in the next number of years despite projected lower budget deficits, there is very little room for fiscal policy to stimulate the domestic economy should the Greek problems result in an European GDP growth relapse.

More likely is that, in line with the US situation outlined above, the first interest rate increase in SA (BER forecasts 2011Q1) may be postponed. A scenario of keeping rates at current levels for longer rather than cutting the repo rate further - which is possible if European conditions deteriorate rapidly - is more likely if the rand weakens amid weaker global growth and higher risk aversion.

A softer rand will, all things being equal, push up the central bank's inflation forecast, limiting the scope for a further interest rate reduction(s) to support domestic growth. Given that the SARB is a flexible inflation targeter, it is unlikely to hike the repo rate if uncertainty remains about the SA growth and thus employment outlook.

Conclusion

The fiscal history of Greece suggests that there is a fairly high probability that the country will default / reschedule some of its debts. The timing of such an event is impossible to predict, but while the government may initially honour the austerity commitments, once it starts to negatively impact output and employment, the political will to implement the fiscal adjustment will be tested. With the still fragile nature of the growth recovery in Europe, as well as the large exposure of European banks to Greek and other periphery EMU country debts, a default could be a significant blow to the European growth recovery.

The impact of a euro-zone growth relapse - or in the worst case scenario a double-dip recession - could be widespread as, for example, more than 20% of US exports go to Europe. The knock-on effects could also dampen the US growth rebound, especially in an environment where the US dollar continues to strengthen versus the Euro.

Given that Europe remains one of SA's most important trading partners, an even weaker than assumed euro-zone growth revival puts downward risks on the BER's export forecast for 2010/11 - especially if commodity prices remain on the recent downward path. Overall, it also raises some risk to our above consensus real GDP growth forecast of 3.4% for 2010. Having said that, the 2010Q1 GDP growth numbers (released next week) are set to show robust growth in the region of 4% q-o-q (annualized). The risk to domestic growth is more in the second half of 2010/2011, which will also be the period when the removal of fiscal stimulus in countries such as the US starts to kick in.

The other key channel through which a further unraveling of the PIIGS crisis will impact the local economy is increased risk aversion with currency volatility (characterized by sudden sharp rand falls versus the US dollar) on the cards. However, against the Euro our current forecast seems overly



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pessimistic with the currency set to remain well supported versus the single currency for the foreseeable future.

Despite recent upbeat data releases on the global real economy, in our view the most important conclusion from the European difficulties is that for the foreseeable future, the balance of risks for the global (and SA) economy is tilted on the downside.

Table 4: Forecast of key economic variables 2010/11

		April '10 forecast	
	2009	2010	2011
<u>Real GDP growth (y-o-y %)</u>			
Final household consumption exp	-3.1	2.1	3.7
Government consumption expenditure	4.7	4.5	3.9
Gross fixed capital formation	2.3	1.5	1.9
Real GDE	-1.8	4.6	4.1
Total exports	-19.5	7.7	6.1
Total imports	-17.4	12.1	7.6
Real GDP	-1.8	3.4	3.5
CPI	7.1	5.3	5.7
PPI (all-items)	0.0	5.7	6.2
Prime overdraft rate (end of period)	10.50	10.00	11.00
R/\$ (Q4)	7.50	7.85	8.38
R/€ (Q4)	11.03	10.68	11.67

Source: BER forecast

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