Africa Economists Retreat, December 5, 2008

The Impact of the Financial Crisis on South Africa

Phindile Ngwenya and Michele Zini
PREM – Pretoria Country Office

Outline

- The Economic Background
- Recent Developments
- Challenges
- Prospects

The Economic Background

- **South Africa has achieved respectable GDP growth and maintained macro stability:**
  - Annual GDP growth averaged 5.1% over 2004-07, up from 3.6% over 2000-03. This was driven by
    - HH consumption and private and public fixed investment on the demand side
    - Financial and business services, construction, and wholesale and retail trade on the supply side.
  - Export growth amidst an appreciating real effective exchange rate;
  - Prudent macroeconomic management resulted in a budget surplus since 2006. Low public debt, high revenue collection and single digit inflation;
  - Rising capital inflows attracted by good economic prospects, resulting in historically high foreign exchange reserves even as CA deficit rose sharply;
  - Deep, well-regulated, liquid financial sector able to borrow in Rand.

The Economic Background

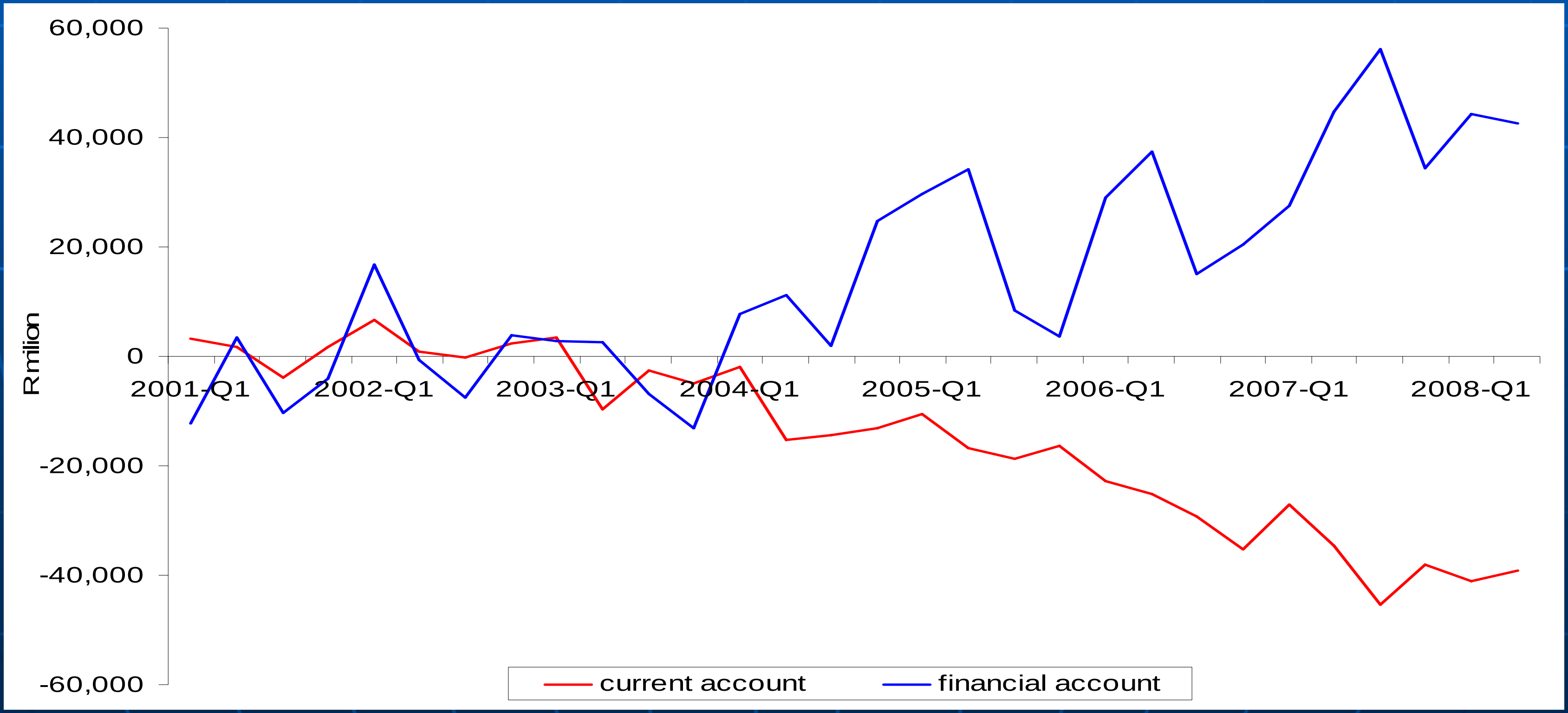
- **Vulnerabilities bubbled to surface:**
  - Extremely high unemployment;
  - Huge inequality, widespread poverty, high crime and HIV/AIDS incidence
  - Underperforming agriculture and mining sectors as well as a struggling manufacturing sector
  - A widening current account deficit
  - High and fast-rising household debt as proportion of GDP. Mortgage loan exposure a concern for banks
  - Growing energy shortages
  - Political developments breeding uncertainty

Recent developments

- **When the global economic storm struck, it found an economy going through a period of internal correction.**
  - Tightening monetary policy since 2006 to contain consumer demand and escalating inflation
  - The National Credit Act came into effect in 2006 to reduce household debt
  - Skyrocketing commodity prices (food and oil) raised inflation expectations and led to tighter monetary policy

Challenges

- **The current account deficit is the main source of macroeconomic vulnerability**
  - But we were not looking at any imminent macro crisis as the economy is robust enough to withstand shocks

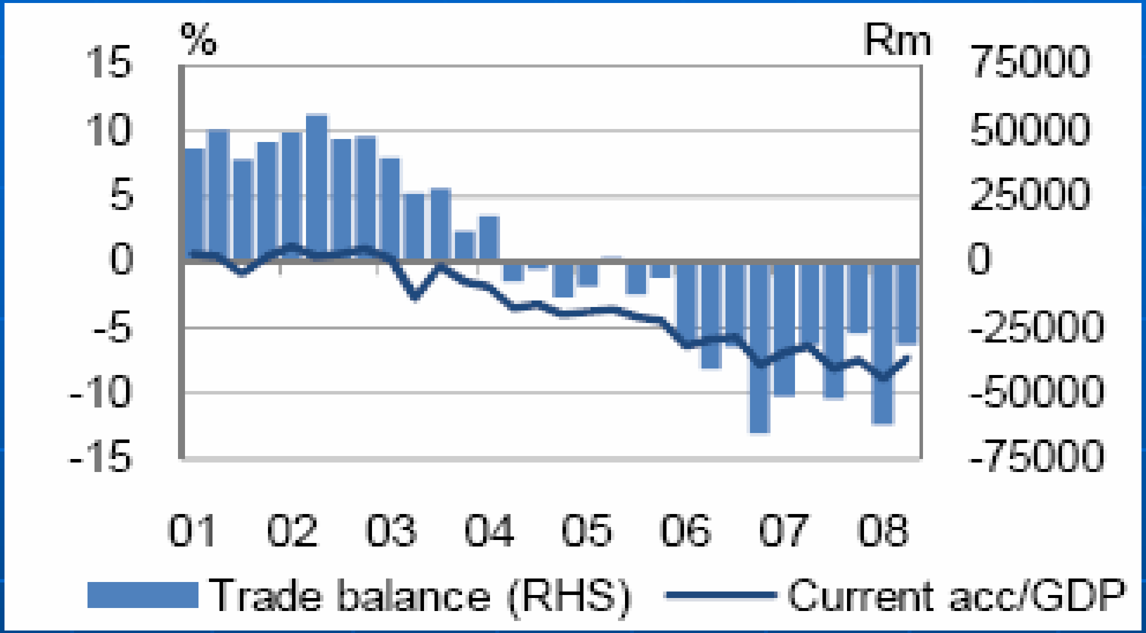


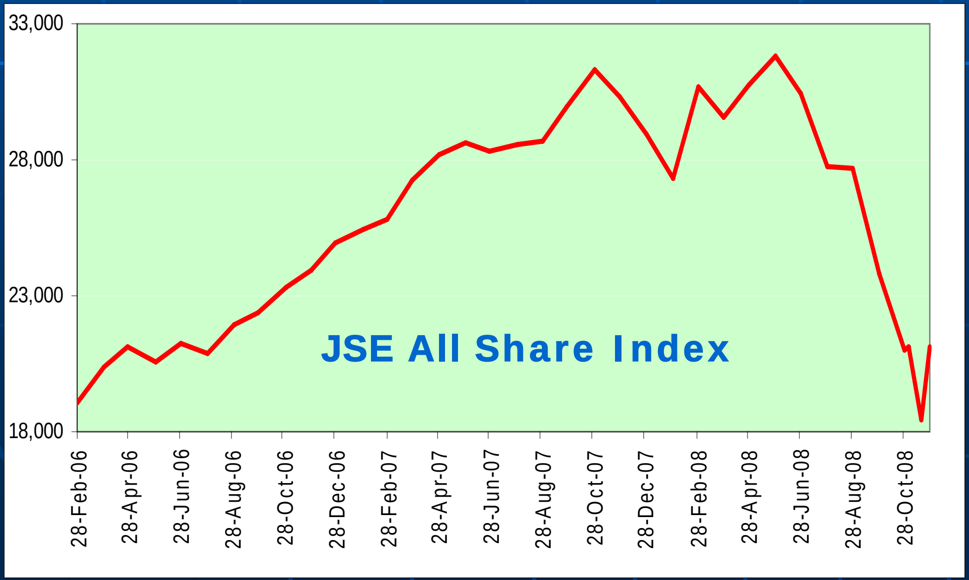
Challenges

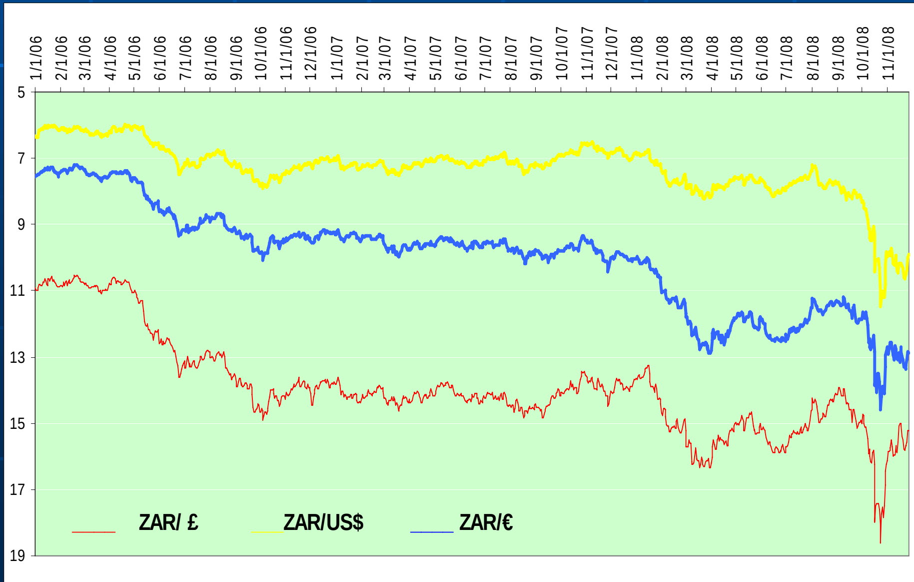
- **The growing current account deficit is financed by the financial account**
- **Sustainability of the current account is of concern, in respect of the sudden stop of capital inflows – typical in developing countries during hard times**
  - Purchase of stocks and bonds by non-resident South Africans moved to negative territory in September and October
  - Equity inflows have declined
  - FDI fell to negligible levels in September
  - The trade deficit increases despite a weaker rand

Challenges

- The trade deficit continues to widen despite a weaker rand
- The rand – like other commodity currencies, has been under increased pressure
- JSE down about 40% after record-levels in early 2008 and remains volatile







Challenges

- **The combination of domestic and international developments has taken a toll on the real economy.**
- **Emerging signs of weakness:**
  - A sharp drop in house prices,
  - Declining domestic vehicle sales,
  - Manufacturing production in the year to September slowed to 3.3%, from 4.4% in 2007
  - The mining sector continues to achieve negative growth, as gold and platinum prices fall and demand in global demand falters
  - Retrenchments are on the increase

Prospects

- **Management of the large CA deficit will remain the main challenge**
  - Lower net exports, limited and costly financing options. CA expected to deteriorate to 9% of GDP.
  - Falling commodity prices will reduce FOREX earnings.
  - Rand depreciation not expected to counter lower demand.
  - FDI is low and fell to negligible levels during 2008Q2.
  - Net purchase of stocks and bonds by non-residents is now negative and expected to decline
  - Capital inflows have been sufficient to finance CA deficit, but now investors are deleveraging. The major risk is associated with sudden stops of capital flows.
- **But in a floating ER regime, no real insolvency issues. Risk is large currency depreciation to adjust CA deficit.**

Prospects

- **The risk is more severe for the real economy.**
  - For the 3 year period ahead, GDP growth is expected to significantly slow
  - Risky proposition for a country with high unemployment and inequality, and growing political uncertainty
- **Sound fiscal position and low debt will allow some cushioning of the economic slowdown**
  - Revenue growth will slow while spending will increase
  - In particular, revenue from corporate taxes and value added tax is expected to come under pressure.
  - Social assistance programs are planned to increase
  - Net effect of countercyclical spending = Negative Budget balance (-1.6%), after 2 years of surplus.

Thank you!