

DETERIORATING GLOBAL GROWTH OUTLOOK HOLDS RISKS FOR SA FORECASTS

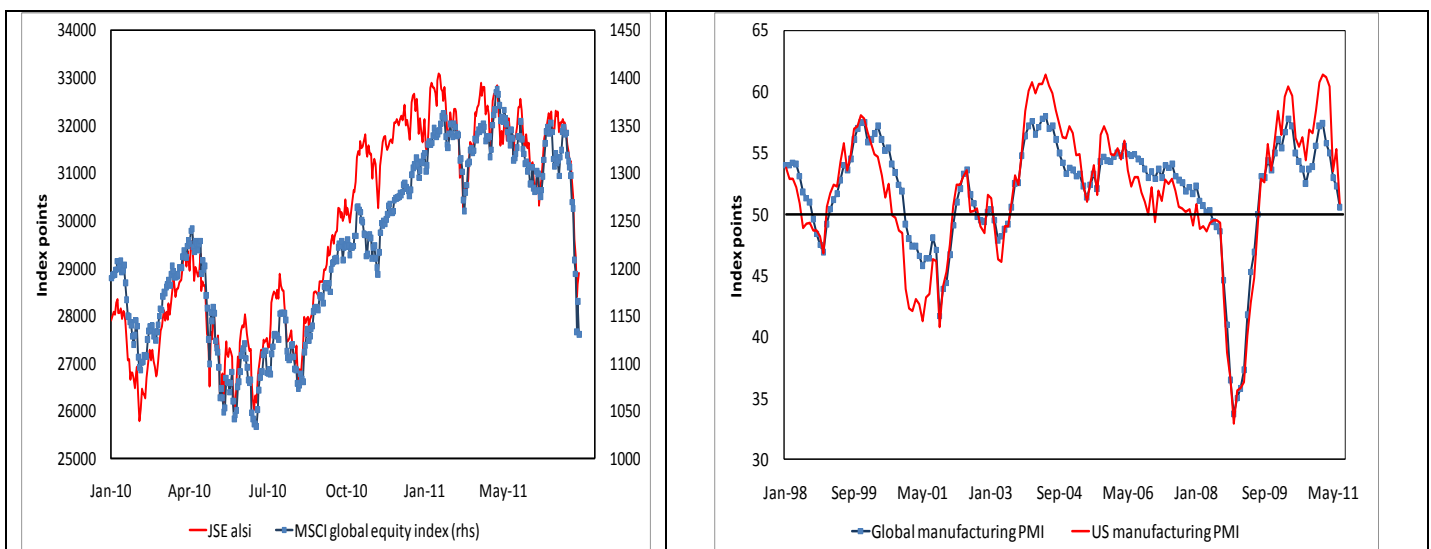
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Introduction – a month to forget

Adverse global economic developments since the release of the BER's forecast update during early July culminated in renewed financial market panic of late. While the downside risks to the global economic outlook were highlighted in the BER's 2011Q3 *Economic Prospects* publication, recent events warrant a re-look at some of the assumptions underlying our forecasts.

A confluence of developments - including worse than expected global growth data, the spreading of EU sovereign debt concerns to larger countries such as Italy and France, as well as the almost unthinkable S&P downgrade of the US credit rating - have seen global stock markets suffer significant losses. As illustrated by figure 1, the MSCI global equity index is down around 14% since mid-July. A stock market decline of 20% is normally characterized as a bear market. If the S&P 500 stock index in the US ends August at current levels, it would be almost 17% lower than three months ago. Typically, declines in US stock prices of this magnitude over a three-month period occur around points of significant weakness, i.e. recessionary conditions in the US economy. Domestic asset prices tracked the international trends as the JSE all-share index rapidly declined below the key 30,000 index point level.

Figure 1: Plunge in world stock markets and... Figure 2: ...soft global growth data cloud outlook



Source: Reuters / JP Morgan

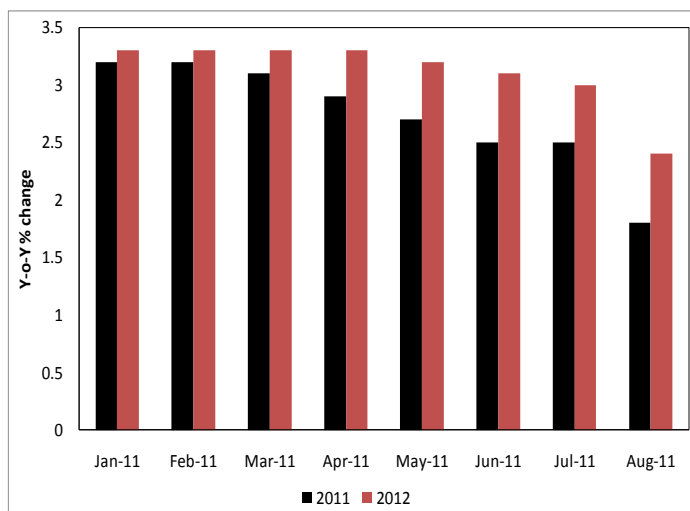
The investor flight to (perceived) safety amongst other factors resulted in record-low yields for US Treasury bonds, multiple new record highs for the gold price around \$1,800/oz, a sharp sell-off in the Brent crude oil price to \$100/bbl at one stage and a much weaker rand exchange rate. After still trading in the region of R6.70/\$ at the start of August, the local currency weakened sharply and briefly touched R7.50/\$ on 9 August, before settling in a range of R7.10 to R7.20/\$ in recent trading sessions.

The aim of this note is to give an overview of recent developments and to provide a qualitative feel for the direction of change (and the risks) to our early July forecast rather than exact numbers for all the forecast variables. A more detailed update of the forecast will be provided in early October.

Global trends – weaker growth, escalating sovereign debt concerns and financial market panic raise double-dip fears

Financial markets had to digest a lot of negative news regarding the global economy during the last number of weeks. Perhaps of most importance were indications that the so-called growth soft-patch of 2011Q2, which was initially thought to be mainly driven by temporary factors such as the Japanese earthquake and the earlier surge in fuel costs, could be turning into a more prolonged *soft trend* as the initial data releases for Q3 remained fairly weak. Figure 2 on the previous page indicates that after peaking at 57.4 index points in February 2011, the global manufacturing purchasing managers index (PMI) declined for a fifth straight month to 50.6 in July to reach the lowest level since July 2009. The PMI is an early indicator for the health of the world manufacturing sector. A reading just above 50 indicates that global factory sector growth is stalling.

Figure 3: Consensus forecasts for 2011/12 US GDP growth downgraded sharply



Source: Consensus Economics, August 2011

Data released for **US GDP growth** during the first half of 2011 also surprised on the downside. The US Commerce Department reported that the world's largest economy only grew by 1.3% q-o-q (annualized) in 2011Q2. Perhaps the biggest shock was that the Q1 growth number was revised down significantly to 0.4% q-o-q from a previous estimate of 1.9%. The weaker than previously thought first six months of 2011, combined with sluggish job growth, sustained housing market difficulties and the need for restrictive fiscal policy to address the high US public debt levels, resulted in a sharp downward revision to US GDP growth projections for both 2011 and 2012 by private sector

forecasters. The August consensus forecast for US GDP growth in 2012 was slashed to 2.4% from 3% expected during July. The US economy is now projected to grow by less than 2% in 2011.

In reaction to the soft data and financial market difficulties, the US Federal Reserve downgraded their outlook for the US economy and in an unprecedented step, said that it will keep the US policy interest rate at current lows just above zero through mid-2013. Given the rapid speed at which the economic outlook can change, the Fed's announcement should rather be seen as a forecast than a firm commitment, but it was nevertheless a very strong signal of sustained monetary policy accommodation. The Fed's thinking was in all likelihood to keep longer-term US interest rates (Treasury yields) low – the two-year Treasury yield traded close to zero following the announcement. The Fed's step may thus have a similar market reaction than a further round of quantitative easing (QE3), i.e. Fed buying of US treasuries.

Recent commentary from numerous other central banks, including the Bank of England, Reserve Bank of Australia and the SA Reserve Bank (SARB) highlighted that the outlook for growth in the world economy has deteriorated. In that vein, the leading economic indicator for the OECD group of 34 mainly developed countries declined for the third consecutive month in June, signaling a possible peak in the OECD business cycle. Importantly, the leading indicator for fast growing emerging countries such as China and India also continued to decline during June.

It has to, however, be emphasized that the recent economic data for a country such as the US has not been universally weak. US retail sales increased by 0.5% (m-o-m) in July, as expected, but growth in June was revised higher. US employment growth also exceeded market expectations in July, albeit that the unemployment rate remained very high around 9%. The concern is that the more upbeat data releases will not be sustained if the current market turmoil persists. Indeed, the preliminary August reading of the University of Michigan's US consumer sentiment index fell sharply to 54.9 from 63.7 during July. Except for April and May of 1980, this is the lowest reading in the history of the survey, i.e. even weaker than the trough of 55.3 reached in November 2008 at the height of the 2008/9 global recession. Although the sharp drop may have been influenced by the debacle to raise the US debt ceiling and there may be a solid recovery in upcoming months, as with the sharp stock market decline, the low level of consumer confidence suggests that another US recession is on the cards.

As we have highlighted many times before, the major underlying problem faced by mainly developed countries is the build-up of **unsustainably high household and public debt levels**. The difficulty faced by the US and others in dealing with excessive debt levels was emphasized in the run-up to the self-imposed August 2 deadline for the US to raise its in excess of \$14 trillion debt ceiling. Democrats and Republicans only reached a watered-down agreement at the 11th hour on measures to reduce the US budget deficit in future, which paved the way for a rise in the debt ceiling. The political grandstanding had major consequences as the Standard & Poor's rating agency downgraded the US credit rating (from AAA to AA+) after the market close on Friday, 5 August. Importantly, both Moody's and Fitch affirmed their AAA US credit rating.

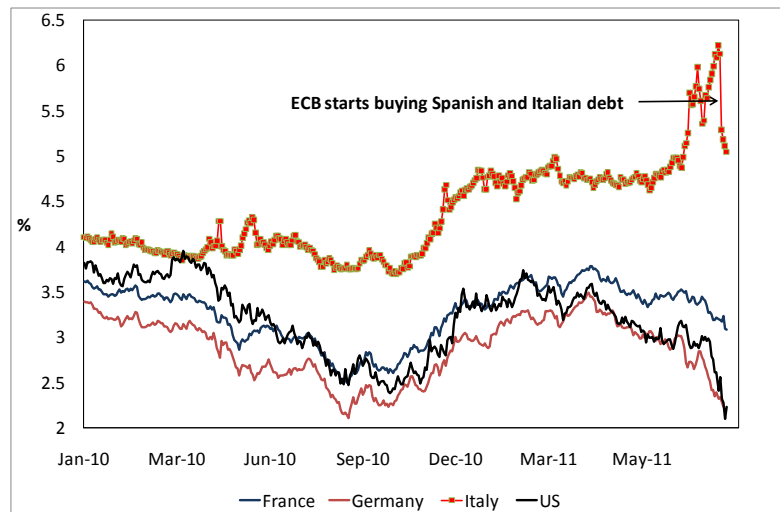
Europe the key risk

Growing concerns about the global growth outlook is having a negative feedback to perhaps the greatest international risk factor, namely the **European sovereign debt crisis**. Weaker growth will increase the already difficult task of countries such as Greece and Portugal to meet strict deficit reduction targets. As a result, investors continue to doubt the ability of periphery countries to stick to the austerity measures that form part of the recent IMF/EU bailout packages. Initial financial market optimism after the second IMF/EU loan package for Greece (announced on July 21) proved to be short-lived as investors fretted about the moral hazard of private sector involvement (PSI).

The second Greek package included that private sector bondholders agree to either exchange, rollover or buy back their existing Greek debt for longer-term debt. In effect Greece will default on part of the debt held by the private sector. While the EU emphasized that PSI would only be allowed in the case of Greece, investors in Portuguese, Irish, Spain and even Italian bonds feared that they may eventually suffer a similar fate. Whereas the IMF/EU tried to contain contagion from the Greek crisis to other periphery European countries, the details of the July package to some extent may have increased the contagion risk.

In order to prevent the sustained rise in periphery government bond yields,

Figure 4: Selected 10-year government bond yields



Source: Reuters

which worsens their debt dynamics, the European Central Bank stepped in to buy the bonds of Portugal and Ireland. At that stage, investor concern had already spread to the possibility that larger European countries such as Spain and Italy would not be able to honour their debt obligations, resulting in their bond yields rising further. Figure 4 indicates that after the ECB was forced to also buy Spain and Italian bonds, the yield on Italian bonds came down. However, it remains substantially higher than the equivalent German 10-year bond. The contagion spread to France, the EU's second largest economy, at the end of last week amid market speculation that the country is next in line for a downgrade of its triple A credit rating. French banks have large exposure to EU periphery debt, as well as French government debt. If France is downgraded, a number of French banks will almost certainly suffer a similar fate, probably followed by other European banks as well. This will be particularly damaging amid estimates that the 90 European banks that recently went through stress tests need to roll a massive €5.4 trillion worth of debt over the next 24 months. A European banking crisis would make this almost impossible.

The stock price of a large French bank such as Société Générale has plunged by a third compared with two weeks ago, forcing authorities in France, Italy, Spain and Belgium to inhibit speculative activity by banning so-called short selling. For the time being, the risk of a French credit downgrade has been contained after all three major credit rating agencies confirmed a stable rating outlook for the country.

Given historical experience that the recovery from a banking / financial crisis induced recession is difficult and protracted, the BER has for some time been of the opinion that developed country growth will, while positive, be below potential for some years to come. *The recent developments have raised the risk that the world economy could suffer another recession with SA Finance Minister Pravin Gordhan quoted as saying there is a 40% possibility of a renewed downturn. Many international forecasters have put the odds higher at 50%.* On a positive note, global stock markets seem to be discounting a particularly tough environment – should this not materialize, markets could experience a nice rebound. At this stage, our baseline view remains that the world will not suffer another recession,

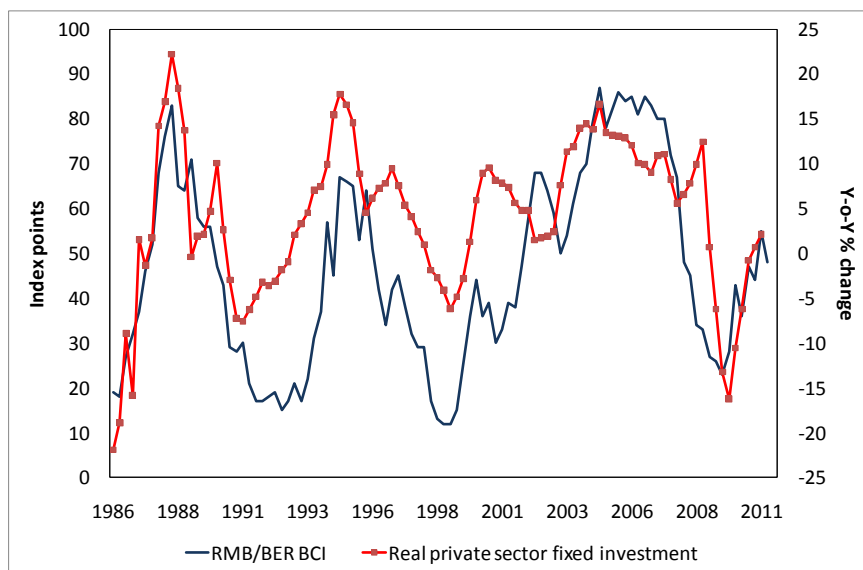
but even our cautious global growth assumptions (G7 GDP growth of 1.9% and 2.5% respectively for 2011 and 2012) now seem too optimistic.

Implications for the SA economy – GDP growth set for a sharp slowdown in Q2, outlook clouded by international events

Even before the latest negativity about the external environment, the incoming data for 2011Q2 suggested a sharp loss of domestic growth momentum. This was confirmed last week when Stats SA reported that seasonally adjusted manufacturing and mining production (together responsible for about 20% of GDP) both increased by less than 1% y-o-y during June.

Combined with weak retail sales data for May, we have downgraded the forecast for 2011Q2 GDP growth to just above 1% q-o-q (annualized) from 3.1% expected previously. If we keep the forecast for Q3 and Q4 q-o-q growth unchanged at 3.4% and 4% respectively, the result is that GDP growth for 2011 as a whole falls to 3.5% compared with the July forecast of 3.8%. Early indications are that growth in the third quarter may also turn out weaker than initially expected. The seasonally adjusted Kagiso PMI declined sharply by 9.7 points to a two-year low of 44.2 index points during July as widespread strikes in the manufacturing sector weighed on production. Mining sector growth is also set to be negatively impacted by strikes in the early stages of Q3.

Figure 5: Any drop in confidence should weigh on private sector fixed investment



Source: BER / SA Reserve Bank

The deteriorating global situation is likely to be reflected in a softening of domestic consumer and business confidence. Figure 5 indicates the close relationship between the RMB/BER business confidence index and real private sector fixed investment. The one channel through which the global uncertainty impacts the SA economy should be a **delay of fixed investment projects**, which has already been slow to recover from the 2008/9 recession. A decline in business confidence also does not bode well for employment creation, especially not in an environment where recent wage settlements again well exceeded the current consumer inflation rate.

The other direct channel through which a weak global economy will impact SA is our **export performance**, which as highlighted in our 2011Q3 *Economic Prospects* publication, has since 2009 underperformed relative to both developing and advanced countries. Although not our baseline view

at this stage, in a negative scenario where the financial market panic is sustained and spills over into the real economy through, for example, negative consumer wealth effects and a sharp decline in business confidence, domestic GDP growth may struggle to reach 3% during 2011.

Regarding the growth outlook for 2012, just plugging in a weaker 2011Q2 number and leaving the rest of the quarters unchanged, results in a small downward revision to 3.6% from 3.7%. However, a more pronounced hit to confidence, investment and exports and the potential spillover to employment and in the end consumer spending, could result in 2012 growth also meandering closer to the 3% mark. We will provide a more detailed evaluation of exact potential growth impacts when we formally update the forecast in early October.

The other more immediate channel through which the local economy is impacted by increased global uncertainty concerns **foreign investor capital flows to SA**. As already mentioned, the JSE and the rand exchange rate declined sharply during the past week or so. At this stage, it is not clear whether the outlook for the currency over the next 18 months has changed materially. There is no question that the rand suffers during times of heightened global risk aversion, but there are other factors that remain supportive to the local currency. Perhaps less important is that the gold price rises during uncertain times and as a major producer of the metal, it may soften the rand's decline. Of more importance are signals from leading central banks, especially the US Fed, that they will keep policy interest rates at current lows for even longer than previously expected. Once the current market turmoil has calmed down, the rand should continue to be supported by investors looking to park their money in higher yielding currencies such as the rand. At this stage, we are sticking with the view that the rand will end 2011 at around R7/\$ and R7.50/\$ at the end of 2012. However, as mentioned in *Economic Prospects*, readers should be alert to the possibility that periods of increased global risk aversion could see the rand weaken sharply at any time in the foreseeable future.

In light of an unchanged call on the rand exchange rate for now and the decline in the Brent crude oil price that brings oil more in line with our July forecast, the recent events have (at this stage) not altered the **BER's CPI inflation forecast** of an average of 5.2% and 5.9% respectively during 2011 and 2012.

Based on the above, the question is how **domestic policymakers** will respond to the renewed uncertainty. We know that the SARB has for some time been concerned about the global economy. The first paragraph of the July MPC statement that accompanied the decision to keep the repo rate at 5.5% provided a clear indication as to the most important issues that the MPC are concerned about. Whereas the first sentence of the previous (May 2011) statement highlights that the domestic inflation outlook deteriorated further, the latest statement starts off by saying that the global economic outlook has worsened in the last number of months. Remember that the July statement was released before the latest global panic – if anything, the SARB will now be even more worried about the global economy and the potential negative spillovers to SA, particularly in terms of the balance of the domestic growth recovery.

As a result, we have shifted out the projected start of the interest rate hiking cycle (+50bps) to March 2012 at the earliest from November 2011. In fact, there is a growing possibility that the monetary policy tightening cycle may only start in the second half of 2012. The repo rate is now only forecast to rise by 100bps through end 2012 compared with 150bps forecast in July. There are two distinct risks to the revised forecast. First, if global risk aversion persists or worsens and the rand suffers significant further losses, let's say sustained trading beyond R8/\$, the central bank may be forced to increase the repo rate earlier in order to prevent higher import costs spilling over into more generalized domestic price pressures.

At the other end of the spectrum, a global double-dip recession scenario may see the SARB resuming with interest rate reduction(s). While none of the scenario's form part of our baseline views at this stage, the interest rate outlook will continue to be re-assessed

Regarding **fiscal policy**, the timing of the latest global developments is unfortunate given last week's announcement that the implementation of **National Health Insurance** (NHI) will cost the country a whopping R125bn in 2012. Minister Gordhan said that the government did not want to unduly increase the burden on taxpayers, saying the insurance programme will be funded through public finances, contributions from employers, surcharges and partnerships with the private sector. The problem is that if the global economy slows down sharply and SA follows, domestic public finances will in all likelihood be in worse shape than currently foreseen, pushing up the budget deficit even in the absence of the introduction of NHI.

Given the heightened focus on fiscal sustainability globally, higher domestic deficits could see a key source of foreign capital inflows to SA (i.e. foreign buying of SA government bonds) dry up with negative consequences for government's interest bill and the rand.

Table 1: Forecast of key economic variables 2011/12

		July'11 forecast (updated)	
	2010	2011	2012
<u>(y-o-y %)</u>			
Real GDP	2.8	3.5	3.6
CPI	4.3	5.2	5.9
PPI (all-items)	6.0	7.5	5.4
Prime overdraft rate (end of period)	9.00	9.00	10.00
\$/R (Q4 ave)	6.91	6.98	7.45
€/R (Q4 ave)	9.40	9.84	10.06

Source: BER forecast

Hugo Pienaar
 Bureau for Economic Research

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