What does Western Economic Crisis Mean for South Africa?

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Context for Europe's Crisis

Global economic relations

- What is the international monetary system?
  - It is the combination of all the mechanisms and strategies nations use in their international economic relations
- Role of the market in these economic relations:
  - Policymakers choose the level of how open or closed an economy is to international trade and financial flows and other economic relations
  - There is a continuum of closed to open
  - No economy is totally open of closed

Balance of Payments

- In intl econ relns a country has 2 accounts which have to be balanced:
  - Current account – trade
  - Financial account – borrowing and lending (capital flows)
- In internl econ relations a country can spend only:
  - Past saving
  - Current earnings and
  - Current borrowing
- If spending & income diverge too much adjustment needed to balance international accounts. If
  - X > M you have to borrow from abroad
  - X<M you have to lend to foreigners

Market forces & adjustment

- Policymakers faced with large divergence between income and expenditure can choose to:
  - **If closed**: remain closed & implement regulations to further tighten trade or capital flows
  - **If open**: close their economy or
  - **If committed to openness** – 2 options:
    1. Adjust level of economic activity (interest)
    2. Change the exchange rate

- Both forms of have large impact on society
  - Higher interest rates or weaker exchange rates mean
    - less investment & employment
    - Lower incomes and real wages

Interest of capitalist class

- Closed econ limits movement of wealth abroad for:
  - Political reasons
  - Investment for higher returns
- Closed economy may limit ability to access largest market for big exporters or foreign investors
- Can counter working class demands for higher wages or social & economic reforms on the grounds that it will decrease international competitiveness & negatively affect balance of payments

International monetary order

- Most powerful capitalist nations usually
  - use their military & economic power to shape the international monetary order
  - prefer very open global economic order to take advantages of opportunities to profit in other countries
- However, have to ensure enough stability to make system work
  - What does this mean? Reducing the pain of adjustment
  - Weaker countries may close economy if international credit unavailable

Shifting power relations

- The international monetary order will be affected by shifting global power relations
- Challengers may want changes to the system
  - e.g., latecomers may be overburdened with adjustment costs
- The challenged power may find their economic dominance reduced & bend rules,
  - e.g., increasing trade deficit, drawing in capital & forcing adjustment on other countries
- Result:
  - New system reflecting new power relations or
  - Breakdown of system

The Sovereign Debt Crisis

The effect of Monetary Union

- Monetary union has removed or limited the freedom to set monetary and fiscal policy, thus forcing the pressures of economic adjustment onto the labour market.

- Maastricht treaty (& Growth & Stability Pact):
  - Washington consensus type policies –
  - Macropolicy : Inflation low and Gvt deficit to GDP not > 3%;

- Eurozone countries entered a „race to the bottom‟ encouraging flexibility, wage restraint, and part-time work.

- race has been won by Germany squeezing its workers hard in the aftermath of reunification.

- Structural BoP Imbalances: Eurozone an area of entrenched current account surpluses for Germany, financed by current account deficits for peripheral countries.

- Monetary union is a „beggar-thy-neighbour‟ policy for Germany, on condition that it beggars its own workers first.

- With GlobalFinancial Crisis(GFC), ECB injected much liquidity into markets BUT in 2009 it did not
- Krugman NY Times 29/4/2010: “
  - “The fact is that three years ago none of the countries now in or near crisis seemed to be in deep fiscal trouble. Even Greece’s 2007 budget deficit was no higher, as a share of G.D.P., than the deficits the United States ran in the mid-1980s (morning in America!), while Spain actually ran a surplus”

- The ECB watched as interest rates rose, financial institutions speculated against state debt, and state bankruptcy raised its head.

- Confronted with a public debt crisis, peripheral countries have been forced by the eurozone to impose harsh austerity. Yet, until early 2010, they have received no bridging loans to ease the pressure. This is grossly damaging, and offers no assurances of future growth.

Banks take advantage of GFC

- Bank take funds from ECB and core eurozone banks continued to lend heavily to peripheral borrowers in the mistaken belief that they were a safe outlet.
- During 2007-8 banks of core eurozone countries (Germany, France, Netherlands, Belgium) had continued to lend to peripheral countries (Italy, Spain, Ireland, Greece, Portugal).
- Gross cross-border claims from core to periphery reached 1.5 trillion euro in 2008, representing almost three times the capital of core banks.
- Accelerated public borrowing in 2009 was induced by the crisis, and hence by the earlier speculations of the financial system. In this respect, the Greek state was typical of several others, including the USA and the UK.
- Then banks became reluctant to lend states issue debt, which becomes area for speculation and attacks – hence the sovereign nature of the debt
- Greece was 1st easy target but was only the beginning of the speculative attacks

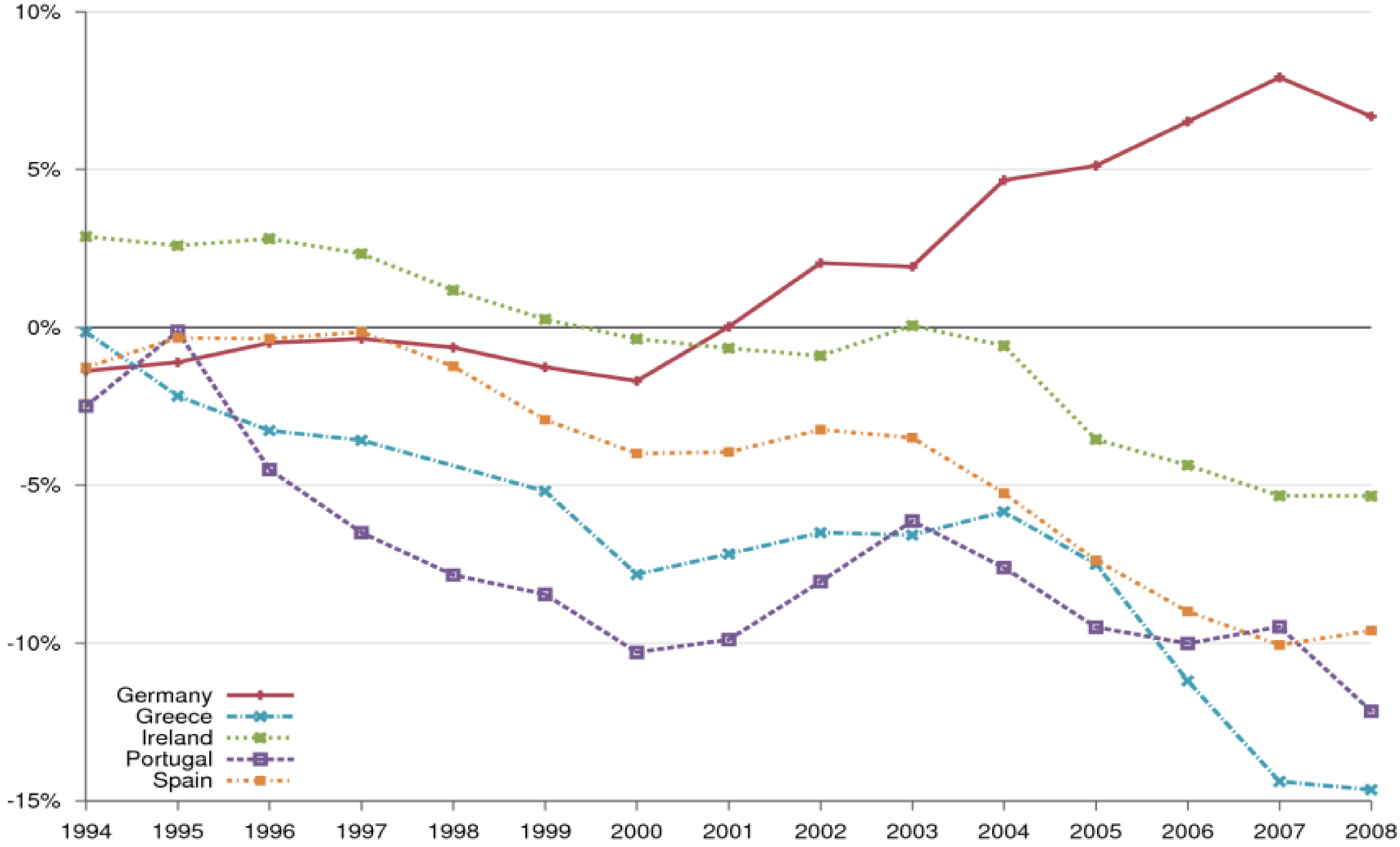
Germany

- The German economy has performed poorly, with low growth, weak productivity gains, and high unemployment.
- Germany has been able to keep down inflation as well as the nominal remuneration of labour.
- Peripheral countries have performed generally better, but labour costs and inflation have risen faster.
- Germany has gained competitiveness within the eurozone for the sole reason that it has been able to squeeze its workers harder.
- Inevitably it has generated persistent current account surpluses against the periphery. The surpluses were turned into foreign direct investment and bank lending to the eurozone.

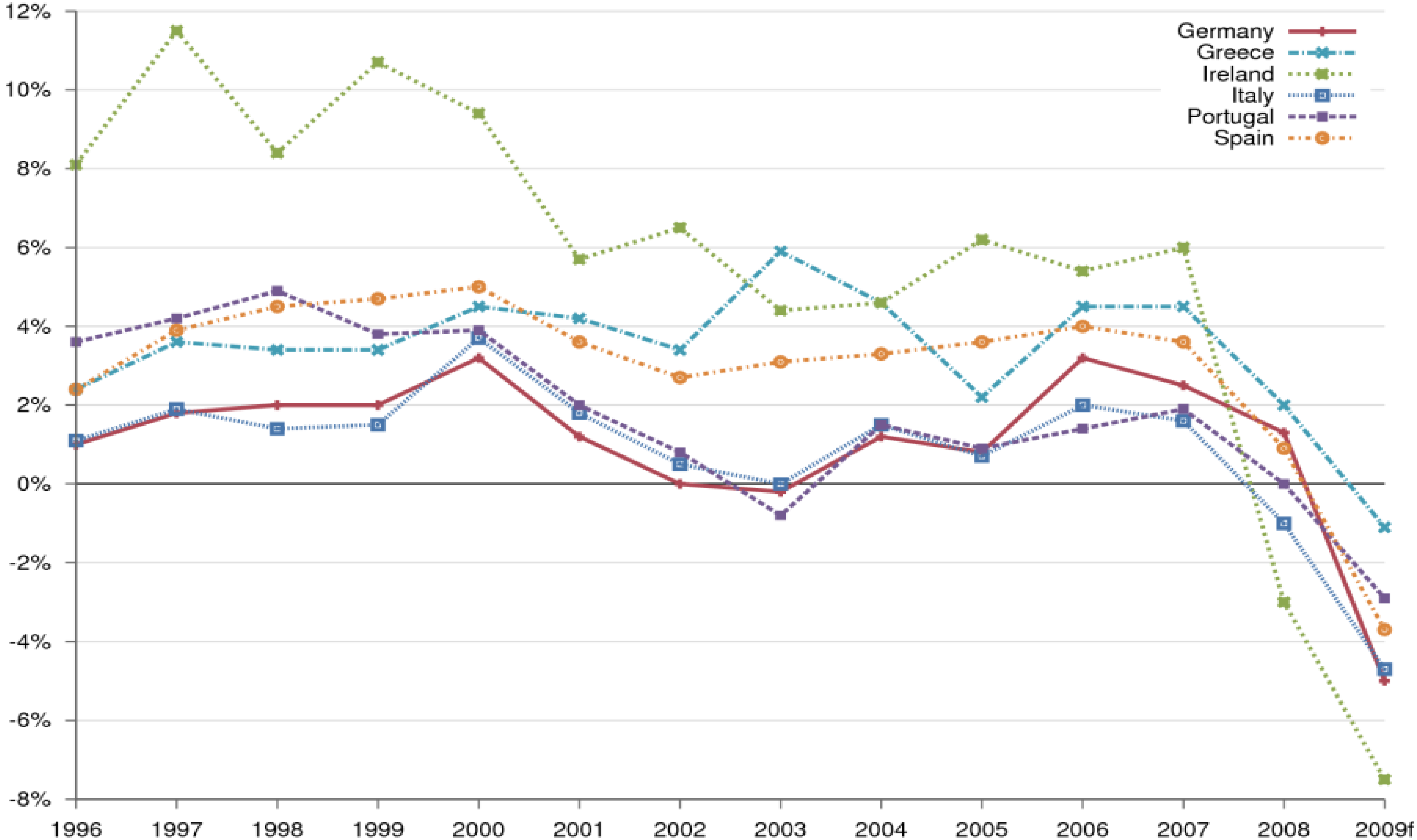
The Peripheral countries

- The sovereign debt crisis that broke out in Greece at the end of 2009 is fundamentally due to the precarious integration of peripheral countries into the eurozone.
- They entered EU with strong exchange rates and
- Their situation declined as German productivity and wage repression further undermined their competitiveness
- Outcome
  - Greece and Portugal sustained high levels of consumption
  - Ireland and Spain had investment booms that involved real estate speculation.

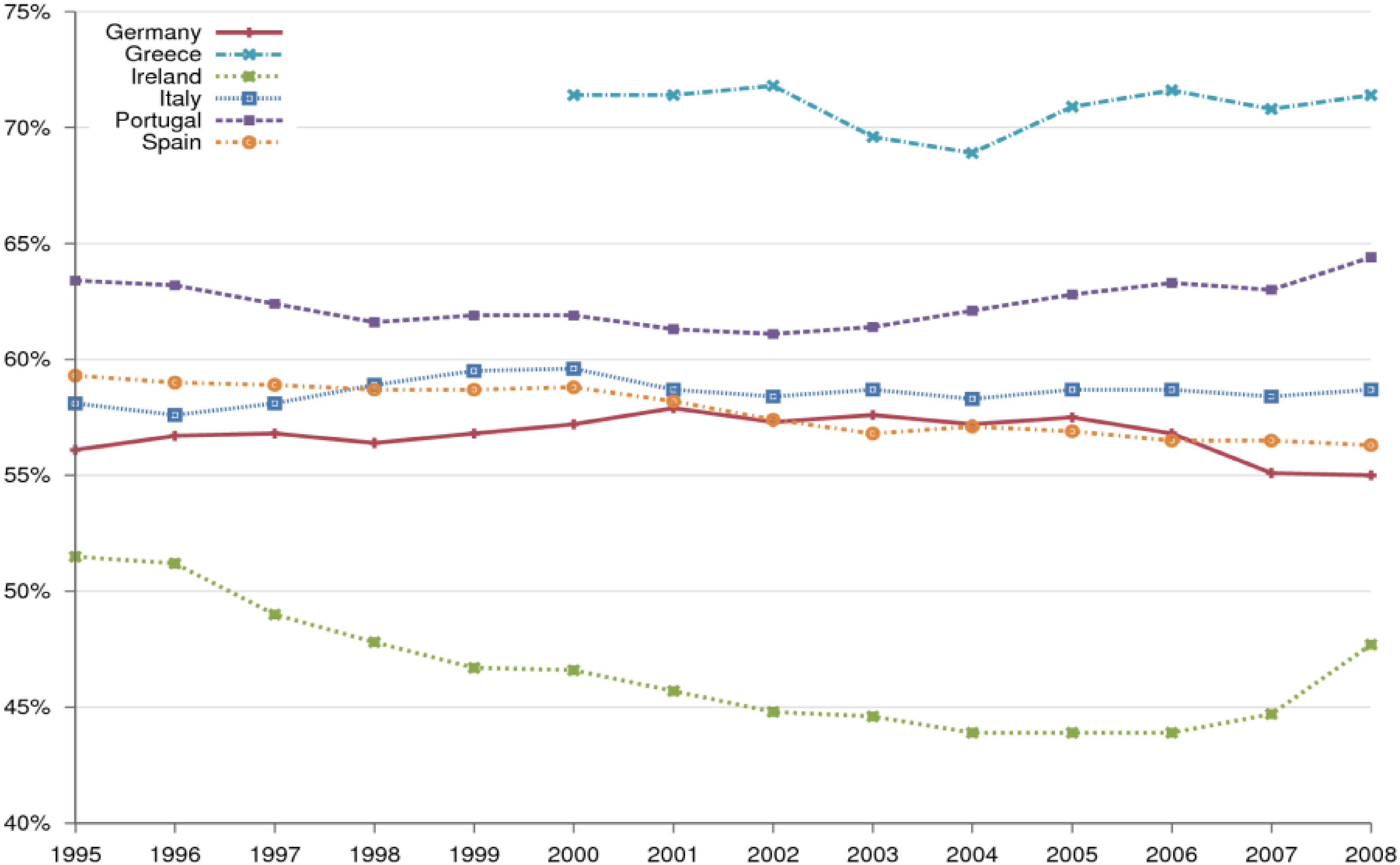
Current account balance as % GDP



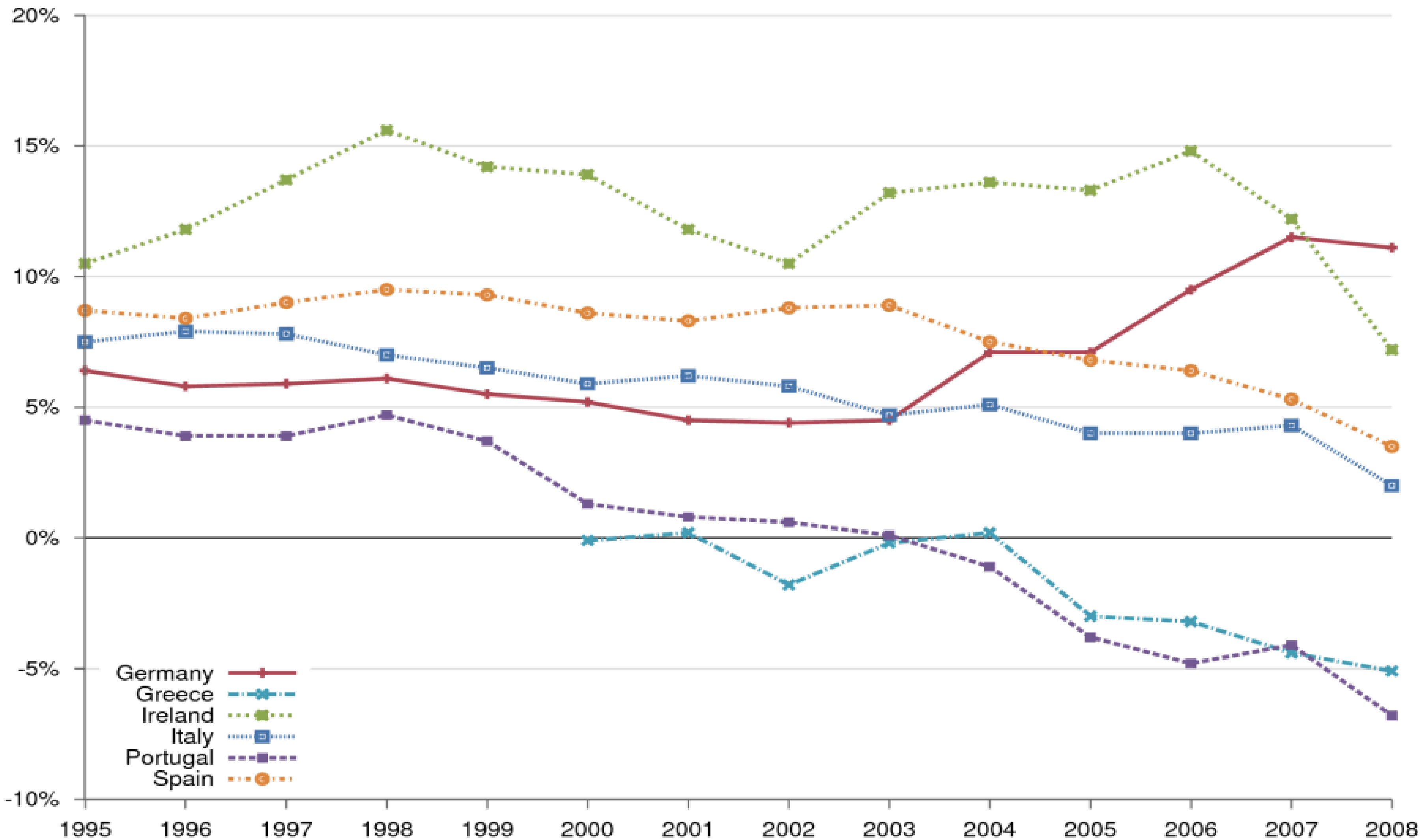
Europe GDP growth rates



Household consumption as % GDP



Savings as % GDP



Adjustment

- The agreements have all shifted the burden of adjustment onto the poor
- All adopted austerity programmes hoping to reduce public borrowing requirements:
  - cut wages,
  - reduced public spending and
  - raised taxes
- Accompanied by ‘structural reform’:
  - further labour market flexibility,
  - reducing pensions
  - Privatisation (including SOEs, health and education)

Wrong policies

- Adjustment by cutting spending is precisely the wrong action
- Countries are forcing themselves into recession/depression through cutting spending and increasing unemployment and incomes
- It is becoming widespread and will cause a cumulative decline in global aggregate demand and economic growth
- Ultimately, the recession will spread from the ‘deficit’ countries to the surplus countires

More context: **Global financialisation**

In a Nutshell:

- Major global corporations increasingly controlled global markets and global value chains
- Shareholder value movement drove them towards short-term high returns in financial asset markets rather than long-term productive investments
- Global value chains allowed increased productivity for shareholders in North even though their production base declining because they shifted production to low cost Asia and continued to get cheap raw material inputs from Africa and Latin America

Financialisation

- Definition: huge growth of the role and contribution of the financial sector in the economy and significant growth in the share of income of non-financial enterprises from financial assets
- It affects every aspect of our lives:
  - The way we buy homes
  - Save for retirement
  - Insure against sickness and other adversity
  - Our incomes depend not only on wage/salary but performance of markets
  - New fragmentation in society & working class
- Here focus on corporations & corporate structure

Financialisation & corporations

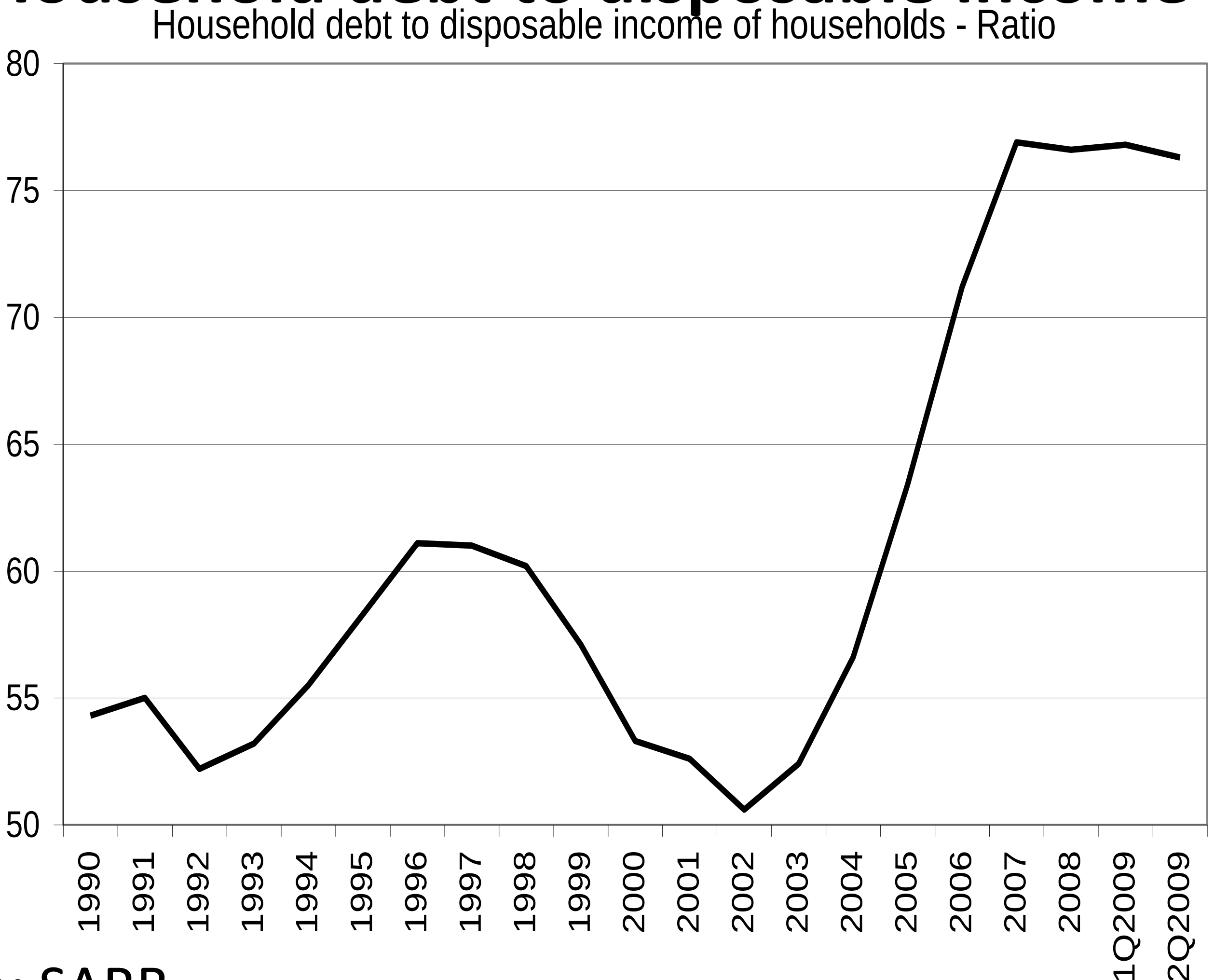
- Change in structure of financial markets led to increasing power of institutional investors:
  - Pension funds, insurers, hedge and private equity funds
- Became known as the shareholder value revolution
  - Focus of corporate governance became maximising shareholder value – response to principal-agent problem
  - Alignment of shareholder value movement & mgt
  - Use of share-options & performance based income for executives, which is now greater than basic income
  - Move towards short-term returns vs long-term productive investment
- **Neo-liberal Paradox**: Push for higher short-term returns when increasing competition & downward pressure on profits in product markets

Financialisation of non-finl corpns

- What do institutional investors, the shareholder value movement & the business media demand from corporations:
  - Increased responsiveness to equity holders
  - Simpler corporate structure – easier to monitor control & allocation of capital
  - Focus on core business – increasing returns to marketing & branding
  - Increased control over global markets
- Result was huge changes in global corporate structure & global market concentration

SOUTH AFRICA

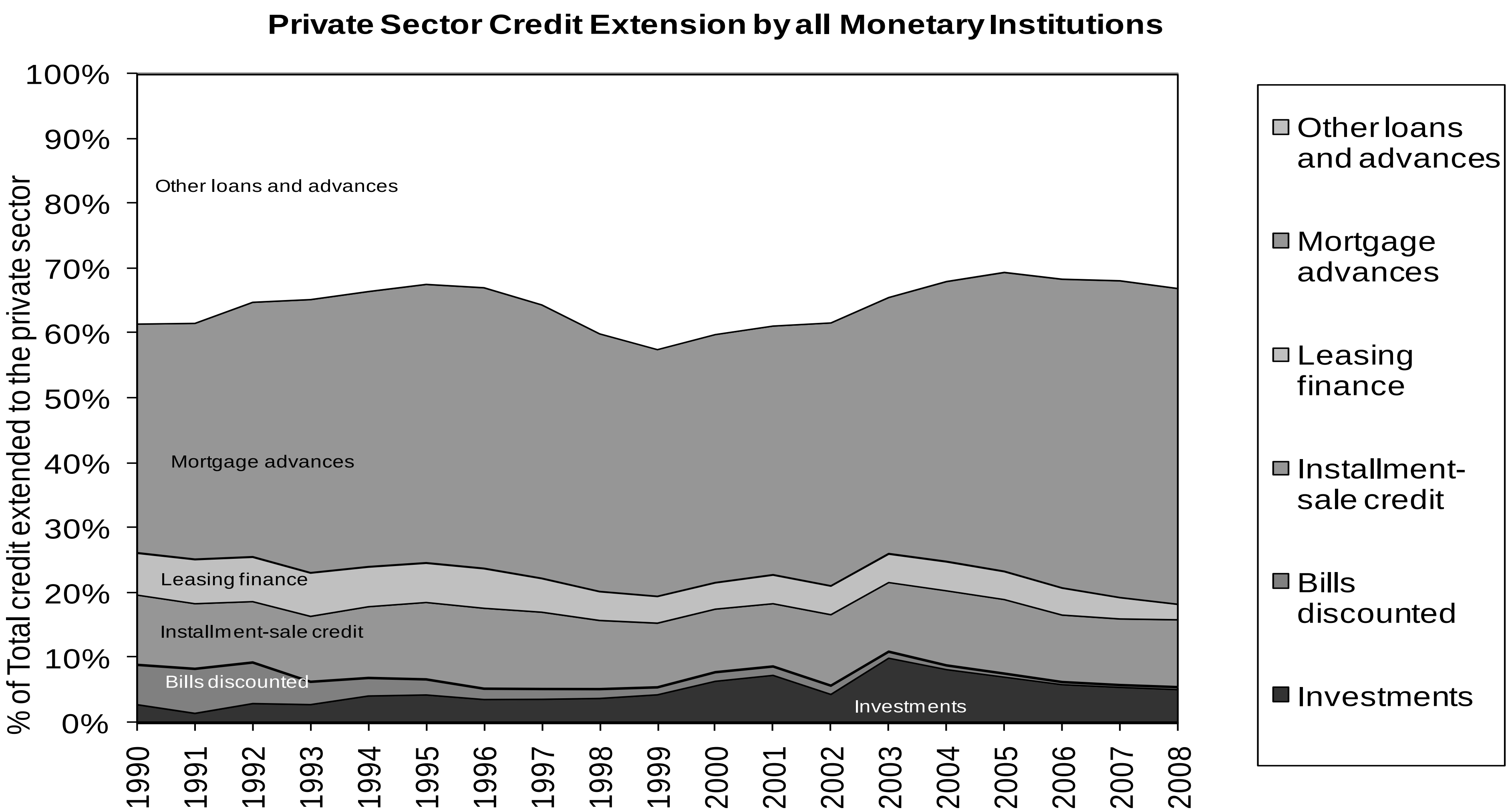
Household debt to disposable income (ratio)



Source: SARB

Allocation of capital by private sector:

- mostly for credit cards, car finance &mortgages;
- mostly for short-term and collaterised debt



Sources and uses of capital in coporate business enterprises