



## GLOBAL ECONOMY – A RECOVERY SLOWLY PLAYING OUT

At the time of writing the April report, it was relatively early in the current COVID-19 crisis with respect to infection rates and lockdowns of economies. We then warned of enormous uncertainties around infection rates, the duration of lockdowns and economic impact – uncharted territory for the global economy. I postulated that the cycle would likely be in the form of a “V” shape and while a deep downswing was expected, it would be of a relatively short duration and the recovery would likely be quite rapid as lost production is recovered. There are still significant uncertainties around the spread of the virus worldwide. While a potential second wave of infections in Asia has not yet materialised and infection rates in Europe have eased markedly, the outbreak in the US is outpacing the experience in many other countries. Similarly, the infection cycle continues almost unabated in Latin America. Nevertheless, to a large extent, the expected reopening of economies has happened from late May onwards.

There has been significant pushback around late March and early April against the view of a V-shaped cycle, but recent data has presented sufficient upside surprises that have strengthened my view that a V-shaped cycle is the most likely outcome. One of the lessons from the Global Financial Crisis (GFC) was that the cycle would likely be V-shaped – a deep recession, followed rapidly by a sharp recovery. Similar to the GFC, my main concern is around economic growth after the initial recovery (or the upleg of the “V” cycle).

While there are similarities to the GFC, there are also crucial differences – which makes this cycle even more likely to be of a shorter duration. The current crisis was the making of an exogenous shock (COVID-19), which led to lockdowns of economies – there were far fewer cyclical imbalances now than before the GFC, the financial system is in a much better shape and deleveraging should also be more moderate than during the GFC. Policy support this time around was again quick off the mark, but far more decisive and sizeable than during the GFC. Fiscal policy support was targeted more at non-financial businesses and consumers (versus more aimed at financial sector support during the GFC) and monetary policy support (apart from interest rate cuts) was also far larger in terms of quantitative easing (QE) than during the GFC. The reopening of economies should therefore lead to a far quicker recovery.

As economies reopened, employment recovered, consumer spending rebounded and production restarted. In the US, the extent of job losses during the lockdown period was truly shocking, but the recovery has already started. A total of 22.2 million jobs were lost during March and April 2020 and 7.5 million of those were recovered during May and June. This recovery will likely continue over the next few months. During the GFC, the peak-to-trough jobs cycle lasted two years from February 2008 to February 2010, during which

8.6 million jobs were lost. From February 2010, it took more than four years (to May 2014) to recover all the jobs lost. In line with the jobs recovery in the US, retail sales have already rebounded more strongly than expected.

Globally, purchasing managers’ indices (PMIs) have recovered sharply as economies reopened from China, to Europe and the US (the three most important economic areas). The Global Manufacturing PMI (as calculated by JP Morgan) fell to 39.6 in April (not as far as during the GFC, when it reached 33.8 at the low point – probably because the rolling lockdown and reopening from China to Europe, to the US did not occur at the same time, thus softening the blow) and has since recovered to 47.8 in June. While this is still below the neutral level of 50, the recovery has already been remarkable. Similarly, the services component of this global PMI fell to a low of 23.7 in April and recovered to 48.0 in June.

The bottom line is that despite the risks on both sides of the virus (renewed infection spikes versus news of potential vaccines) this cycle is largely playing out along the shape of a V. This does not mean it will be all plain sailing though. However, that is why policy support will continue to be extensive and long-lasting. Already, central banks are worried about deflation. Lower than expected readings of core inflation rates (i.e. excluding the impact of food and energy prices) will keep policymakers attuned to the need for continued expansionary policies. In the US, the underlying pace of the Federal Reserve (the Fed)’s preferred inflation measure (the core PCE deflator) has slowed sharply and more deeply than during the GFC. Another key learning from the GFC was that, despite the significant policy support, inflation continued to move lower for far longer than expected. I expect the same situation to unfold now – inflation will likely continue at a lower pace for a longer period, with more risk for deflation than inflation – keeping central banks very much alert.

Despite the unfolding recovery, there are many risks and markets could be volatile for some time – especially when deeply negative second quarter GDP data is released.

My latest growth forecasts for the main areas are:

Global growth forecasts in perspective:					
	Actual growth		Forecasts		
	2009	2019	2020	2021	2022
<b>USA</b>	-2.5	2.3	-5.2	3.2	2.5
<b>China</b>	9.4	6.1	2.0	8.5	6.0
<b>Euro Area</b>	-4.5	1.2	-6.2	6.3	1.5

## SA ECONOMY – A TEST FOR A SUSTAINABLE RECOVERY

In South Africa, the situation is far more dire than in the rest of the world. While a deep downswing followed by a sharp recovery is also expected here (the V-shaped cycle), the sustainability of the recovery over the medium term remains in serious doubt and of deep concern. Let's explore.

The same reasoning for the “V” in the global economy applies to South Africa. The collapse in activity was followed by a rebound as the lockdown eased and activity restarted. The global recovery will also help the local economy. Similar to the global cycle, I expect a deeply negative real GDP growth number in 2020 in SA and a sizeable positive growth number next year. My concern is the outlook for the SA economy over the medium to longer term.

Having experienced sharply lower economic growth over the last decade, all the main variables that are important for foreign investors and ratings agencies – the budget balance and the debt ratio (government debt as a percentage of GDP) are the most important ones – had deteriorated substantially even before the COVID-19 crisis hit. The subsequent economic collapse and resultant impact on these variables will make it even more difficult to set the economy right.

To emphasise the dire situation, take a look at these numbers:

- **Growth:** Annual average real GDP growth over the ten years ending 2019 was only 1.7% p.a. – less than half the 3.6% growth (on the same basis) recorded in the previous ten years. Over the last five years to 2019, average annual GDP growth was even weaker – only 0.8% p.a. The situation worsened further recently, as the economy has recorded negative growth for four out of the last five quarters – and continuously since July 2019 – thus being in recession even before the onset of the current crisis.
- **Budget balance:** From 1994 onwards, lower deficits were recorded as growth picked up until a budget surplus was recorded in 2007 and 2008, at the onset of the GFC. Since then the balance has deteriorated sharply – firstly, as a result of the GFC-induced local recession, and then weaker growth and an inability to correct the deficit through more serious intervention. So, from a surplus in 2008, to a 15.7% deficit this year.
- **Debt ratio:** Thanks to the stronger growth and lower budget deficits in the late 1990s and early 2000s, the debt ratio improved to around 26% (debt as % of GDP) by 2008. Then the deterioration came along with growth and bigger deficits. Last year the debt ratio was 63.5% and it will reach 81.8% this year.

This brings us to the Supplementary Budget of June 2020 – in reaction to the economic fallout from the COVID-19 crisis. While the numbers in the Budget were truly horrific as expected, the message was clear that the attention needs to be on fiscal consolidation. While this is commendable, the consolidation targets of a primary surplus (i.e. budget balance excluding interest payments) by 2023/24 (from 11% deficit now) and a stabilisation in the debt ratio at 87.4% (also in 2023/24) will be close to impossible to achieve without growth-enhancing policy reform. Also worthy was the aim to achieve these goals largely through extra spending cutbacks, with far less emphasis on extra tax measures. Again, without growth-

enhancing policy reform this will have a deeply negative impact on the economy.

The Minister of Finance described the Budget as a “bridge” to the October Medium-Term Budget Policy Statement (MTBPS) and promised that Government “will prepare a set of far-reaching reforms” before then that “will stabilise public debt”. The cynics amongst us will argue that we have heard these promises before – many times – over the last few years.

But there might be reason for slightly more optimism this time around, in terms of the planned expenditure cutbacks and promised policy reform. Firstly, the planned spending cuts of R230bn over the next two years may be somewhat easier to achieve than what we thought initially. National Treasury was able to cut spending by R100bn between the February and June Budgets alone. Slower planned spending on state-owned enterprises (SOEs) will also help. Thus, a R230bn cutback over two years might be feasible. Also, Government remains steadfast in the planned R160bn savings from the public-sector wage bill (announced in February) despite significant union pushback.

The likelihood of serious policy reform may also now be somewhat higher than previously thought. The US\$4.2bn emergency IMF loan comes with the condition that Government should stabilise the debt ratio. The threat of a full IMF structural adjustment programme in the absence of policy intervention could be the impetus needed to make unpopular decisions. The signs have become clearer recently with the President talking about a “whatever it takes” approach to policy change (also endorsed by the ANC’s NEC). Thus, the promised reforms may actually come through this time. Watch this space.

On the monetary policy front, low inflation (May CPI inflation fell to 2.1%, which is below the bottom end of the SA Reserve Bank’s 3% to 6% inflation target range) for longer (headline inflation is likely to remain below

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the 4.5% mid-point of the target range for the duration of the forecast horizon, i.e. through end of 2022), and very weak growth (limiting the ability to pass on cost increases) could mean more rate cuts over the next few months, on top of the 325 basis point reduction over the past year. Headline inflation could remain around or below the 4.5% mid-point of the target range for five consecutive years: 4.6% in 2018, 4.1% in 2019, 2.9% in 2020, 3.9% in 2021 and 4.5% in 2022.

As the global situation stabilises, the massive amounts of QE money in the US will also eventually lead to huge flows into EM bond and equity markets – as it happened after the GFC (the so-called risk-on trade). This should lead to a material strengthening of the rand exchange rate from later this year into next year. Thus, short-term currency moves will likely be dictated by global factors, while the rand’s medium- and longer-term path will be determined by policy reform and the growth outlook.

Despite the many risks around the outlook for the SA economy there are signs that maybe, at long last, serious growth-enhancing policy change could finally be on the cards. While long overdue, time is now of the essence.