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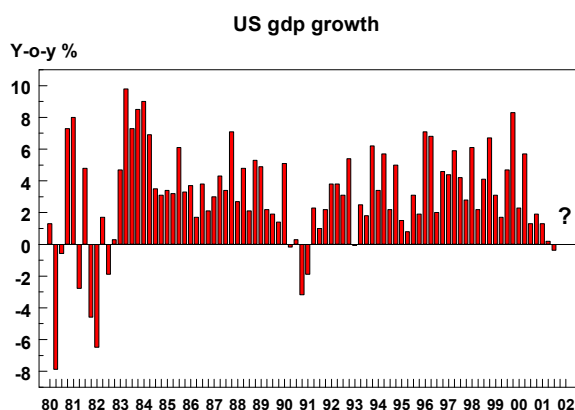
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A GLOBAL RECESSION?

The slowdown in the major developed economies that started late last year has intensified and threatens to become a global recession. The 11 September attacks have probably pushed an already ailing US economy into recession. Unfortunately, neither Europe nor Japan is currently able to take over the role of locomotive from the world's largest economy. South Africa has already experienced the gloomier global climate through weaker domestic financial markets and a further collapse in the rand. However, so far the local economy has held up well. Whether it continues to do so depends on the duration and depth of the international slowdown.

International climate and outlook



There is general consensus that the tragic events on 11 September have worsened the short-term global outlook, but strong debate over longer-term prospects continues. Even before the events on 11 September analysts were divided into two main camps, the optimists and the pessimists. The debate was whether there would be a V-shaped recovery or a U-shaped recession in the US. The V-shaped recovery protagonists held that the slowdown in the US was due to temporary, cyclical factors and that growth would revert relatively quickly to trend. Initially it was hoped that the aggressive monetary and fiscal easing in the US would result in an upswing in the second half of 2001, but this was gradually postponed to late 2001 and now to the first half of 2002.

Believers in a quick recovery have generally also been adherents of the so-called new economy. This view holds that massive advances in technology and improvements in business methods during the 1990s will ensure that longer-term growth rates of over 3.5% will quickly be restored. The current downturn is seen as an aberration, stemming mainly from over-zealous interest rate hikes by the US Federal Reserve in 1999 and 2000, the oil price rise over the same period and the once-off shock to consumer confidence caused by 11 September. If this view is correct, then the 10 cuts in interest rates seen so far this year, fiscal stimulation and the collapse in the oil price will ensure a quick rebound to growth rates seen in the late 1990s.

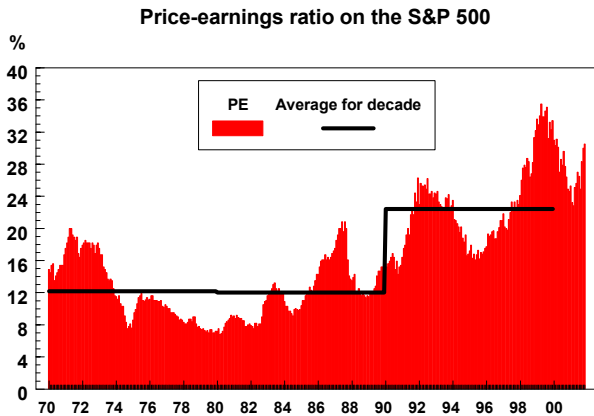
A further implication of this view is that the US equity market is not overvalued at current levels, but is rather reflecting good prospects for earnings over the years ahead. High price-earnings multiples are therefore not a cause for concern, especially since other methods of valuing the market give a more benign view.

Why the US may struggle to recover quickly and strongly

In contrast, the pessimistic school does not see the current downturn in the US as an aberration, but rather as a necessary or inevitable adjustment to significant excesses that built up during the 1990s. This view holds that the Federal Reserve was guilty, not of raising interest rates by too much, but rather too late. This allowed equity and other prices to rise to unprecedented levels during the late 1990s, in turn overstimulating consumer and investment spending. Preparation for the Y2K phenomenon added to this investment splurge, leading many corporates to overinvest generally, but particularly in technology. Once the hype surrounding Y2K was over and it became clear that making money out of internet ventures was at best a very long-term prospect, firms started to cut back on both their hardware and software requirements. This then led to a massive re-rating of technology shares, a flattening out of employment growth and weaker consumer confidence.

In this view the US economy prior to 11 September was therefore already an accident waiting to happen. Evidence of excesses included a personal savings ratio of around the historical low of 1% and a current account deficit of just under 5% of gdp - again a

record and well above international norms. Finally, the equity market was trading at multiples of over 30 times earnings, higher than those prevailing even at the time of the great crash of 1929. Pessimists maintain that, until these excesses are dealt with, future growth will be modest at best.



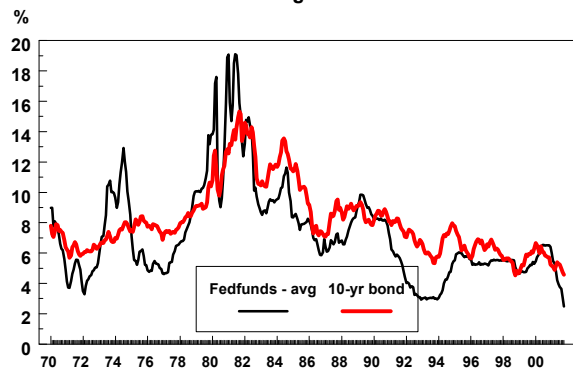
Some are even comparing the US to Japan, where the economy has been unable to recover following the popping of an asset price bubble over a decade ago. The fear is that the US will slide into the same deflationary spiral that appears immune to stimulatory policies.

The 11 September effect

The 11 September attacks will have a number of effects on the economy. Costs include the cost of the disaster in terms of capital, human lives lost and disruptions to various industries such as tourism, travel, hotel and insurance. Potential benefits include the stimulus of various sectors such as the security industry as well as changed government and central bank behaviour. The Federal Reserve has cut interest rates by 1.5 percentage points since 11 September, bringing the target for the Federal Funds rate down by 4.5 percentage points since the beginning of the year to its lowest level in nearly 40 years. The authorities have also helped to push key long-term interest rates lower. The US Treasury suspended sales of 30-year treasury bonds in late October after 24 years of such issues, ostensibly to reduce government's borrowing costs. However, the move is widely seen as a further measure to shore up consumer spending as mortgage bond rates are linked to long-term treasury yields. Many homeowners have taken the opportunity to refinance their mortgages at lower interest rates, unlocking further liquidity and spending power.

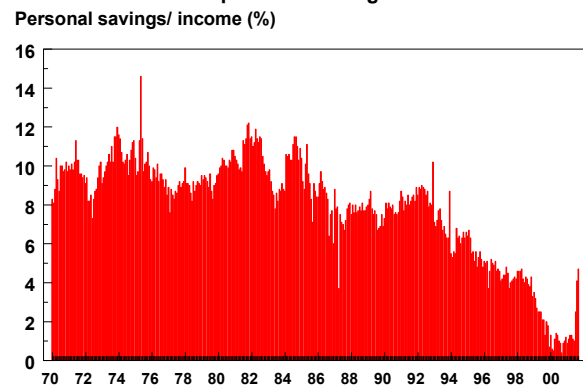
On the fiscal side, Congress is considering a package of measures that, together with various relief packages, will amount to over 1,2% of gdp. However, the initial impetus following the disaster has been lost and various political struggles are holding up finalisation and implementation. The impact of the package is difficult to assess. Much will depend on the mix of tax cuts and increased spending and whether the present generosity will be recouped in later years. For example, households may react by saving any temporary windfalls to pay the tax bill in later years, especially if confidence is low.

US short- and long-term interest rates



Less easy to guess is the impact on corporate and consumer behaviour. A point of general agreement is that the US consumer holds the key to what may develop over the next few months. If consumer spending holds or picks up, then an upswing may not be far off. In contrast, if consumers decide instead to use tax and other windfalls to increase savings, then a more prolonged recession becomes likely. As US consumer spending makes up around 70% of gdp, any reduction to restore savings levels will have a significant impact on overall economic growth.

US personal savings ratio



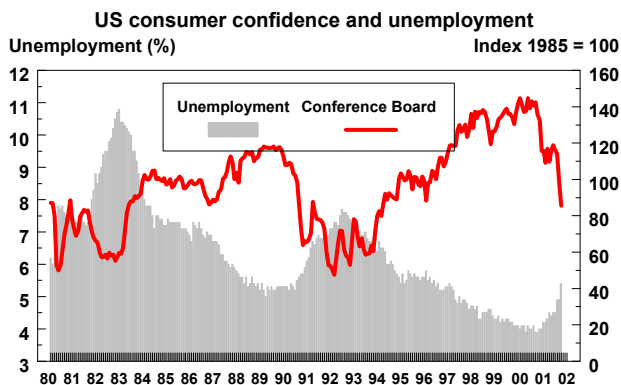
Optimists would argue that the latter scenario is unlikely because personal wealth levels are high, making higher savings levels unnecessary. Despite weaker equity prices, the housing market remains strong and refinancing at lower interest rates has helped owners unlock some of this additional wealth. However, reduced job security is likely to prompt at least some reaction on savings. A downturn in the residential property market would also signal the onset of a deep recession.

Evidence after 11 September

Recent economic evidence from the US has been sobering. Corporate America was already cutting back on capital spending and reducing payroll costs in the face of falling profits, and these trends have intensified. Gross private fixed investment has fallen for five consecutive quarters, while durable goods orders have collapsed for four consecutive months, with the latest figure showing an 8,5% year-on-year

decrease. The National Association of Purchasing Managers' composite index is well below the 42,4 level that signals a recession in the overall economy. Over 880 000 jobs have been shed since April, with the 415 000 decline in payrolls in October being the largest since the 1980 recession. Most firms indicate that further layoffs are likely.

As a result US consumer confidence has deteriorated, with the Conference Board's survey index falling back to levels last seen in the 1990/91 recession. Consumers have already started saving more, with retail sales coming under pressure over the past few months. The exception to this was October, when massive discounting and zero-interest rate packages for motor cars enticed consumers back. However, this is unlikely to last and ironically could compound problems in the months ahead as spending declines after the incentives, putting company margins and profits under even more pressure.



Elsewhere the toll on jobs has been equally worrying. It is estimated that, in 2001, over half a million jobs have been shed worldwide by major corporations, with the trend worsening since September. The losses have been in a range of industries, but aviation, finance, technology and communications have been particularly hard hit. In certain of these industries the downturn has been so severe and the problems have seemed so intractable that analysts are talking of industry depressions that will have far reaching structural implications.

Conditions elsewhere are sombre

The economic climate outside the US is also a matter of concern. The general slowdown is the first synchronised downswing since the oil-induced recessions of the 1970s. Although the downswing in Europe has been the mildest of the three major economic blocs, recent indicators in key economies show that consumer and business confidence have weakened strongly in recent months, with retail sales and industrial production under pressure. For example, in Germany the Ifo business confidence index has fallen to levels last seen nearly a decade ago.

Japan is in dire straits. The economy is in its fourth recession since the bubble in asset prices burst in 1989. It is currently experiencing deflation despite a

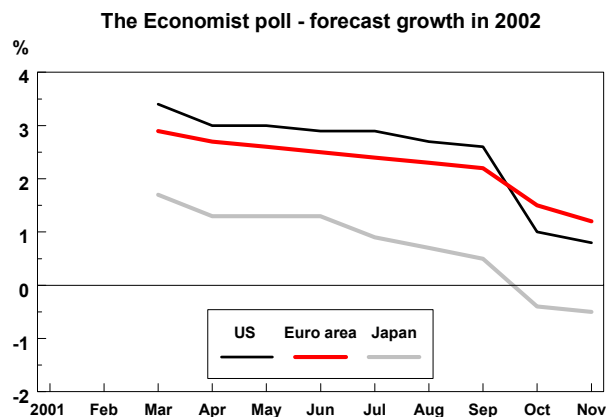
zero interest rate policy. Further complicating the short-term outlook is the new government's desire to address structural problems in the economy and the financial system. While this is desirable to restore the economy on to a better long-term growth path, it will further depress domestic demand in the short term at a time when external demand is weak.

Emerging markets have borne most of the brunt of the downturn so far. Countries such as Singapore and Taiwan in South East Asia, which last saw recessions in the 1960s, have seen sharp downturns this year as high-tech demand faded. In Latin America the major economies of Argentina, Brazil and Mexico are in recession, with the added complication of a renewed debt crisis in Argentina, increasing risks in the region.

Forecasts and market reaction

Official and private sector forecasts of global growth have been revised down significantly in recent months. In mid-November the IMF had to change forecasts made only in October. They now estimate world growth at 2,4% in both 2001 and 2002, below the 2,5% level that many view as a world recession. The IMF's gdp forecasts are based on purchasing power parity values, which give a larger weight to countries such as China where growth remains relatively strong at over 6%. However, US growth has been revised to 1,1% in 2001 and 0,7% in 2002, down from 1,3% and 2,2% forecast less than two months ago. Japan is now seen as being in an extended recession, contracting by 0,9% this year and 1,3% in 2002 (compared with October forecasts of -0,5% and 0,2%). Among developed economies, Europe is expected to grow at the quickest rate over the coming year. The IMF is now predicting growth of 1,4% in 2002 after 2001's 1,7% expansion. However, this would still be modest and there are fears that structural rigidities in the labour market and bureaucratic impediments will keep longer-term growth in check.

Private sector forecasts show a similar picture. The graph below shows how 2002 growth expectations for the world's largest economies have been successively revised downwards since early this year. The data is taken from the Economist magazine's consensus poll.



These low forecast figures are nevertheless still suggestive of a strong recovery next year. The US would have to expand at an annualised 3,5% in the

second half to recover from the low base at the start of the year.

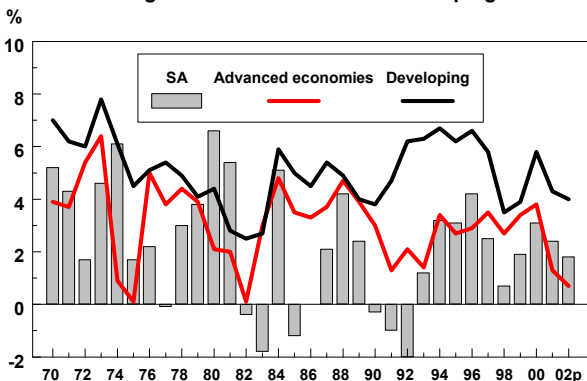
Equity markets, particularly in the US, are reflecting this or even more optimism. Since September 10 (ie before the attack) the broadly based large-cap S&P 500 has risen by 5,4% and the tech-heavy Nasdaq by 14,1%. The price-earnings ratio on the S&P 500 is back above 30. This partly reflects a belief that historically such events have little lasting impact, but also an expectation that the US economic downturn is past its worst. For current valuations to make sense the US economy would have to bounce back quickly and then return to the average growth rates of around 4% seen in the second half of the 1990s. This enthusiasm is based on continued productivity improvements stemming from new technologies and business methods, a belief that the new economy is still in place.

Is this realistic? The short-term dangers include a negative turn in the war against terrorism, leading to a further setback in confidence as well as a slump in demand once the first wave of stimulus measures begin to fade. In the longer term the optimism just does not seem to take account of the imbalances outlined above. Disappointment is bound to set in at some point, although in the short term the momentum is clearly with the bulls.

Equally unlikely, however, is the onset of a Japanese style recession. The US's very different demographics (a younger population), different culture (of spend rather than save) and a quicker and more deliberate policy stance should help stave off deflationary pressures. Another key difference is that the property market is also strong at present. Any mishap in this sector would be extremely dangerous, hence the concerted policy efforts aimed at avoiding such a scenario.

Effect on SA economy

SA economic growth vs advanced and developing economies



South Africa's economy is relatively well positioned to withstand the downturn in the US and global economies. Government finances are in good shape, with the deficit before borrowing around 2% of gdp and total government debt below 50% of gdp and falling. On the external side exports have held up well and the current account will be in an overall surplus of around 0,2% of gdp for 2001 as a whole. As a result of this and low external debt, the country enjoys an

investment grade rating, with the prospect of a further upgrade in the offing. The corporate sector is cash flush and asset prices are under- rather than overvalued. The banking sector is also well capitalised and regulated. Finally, consumer finances are in reasonable shape, with household debt as a percentage of income back to levels last seen in 1995 and disposable income growing comfortably above inflation. In nominal terms interest rates are at their lowest levels in over a decade and in real terms at levels last seen in 1994. In short, there is little evidence of the excesses that are now plaguing certain developed and developing countries worldwide.

South Africa also has relatively weak direct links with the US itself. A recent IMF study shows that only 12% of the country's trade is with the US, well below the 22% average of emerging market countries surveyed, with Latin America (33%) and Asia (19%) the most exposed regions. Perhaps more importantly, total trade with the US amounts to only 4,7% of gdp, compared with an average of 15,1% for emerging market countries. In this respect developing Asia, given its open economies, is more exposed to the US than Latin America, with direct trade amounting to an average of 19,2% of gdp compared with 14,5%.

These relative advantages would, however, be small comfort in a prolonged synchronised global downturn. The IMF study's principal conclusion is that the US does have a significant impact on world growth. South Africa is a small, open economy that relies on good growth in external markets. Total trade forms nearly 60% of gdp, with exports accounting for over 30% of gdp. It is inconceivable that a global downturn of any magnitude would leave the country only mildly affected. The graph opposite shows that South Africa has experienced a downturn with each slowdown in the world economy over the past three decades. The only exceptions have been when the gold price has run strongly on the back of strong global inflation, for example at the end of the 1970s. However, the prospect of a gold price run in the current deflationary environment is extremely unlikely.

Almost 46% of exports are raw or beneficiated minerals and metals, the prices of which are very sensitive to changes in international conditions. Already key export prices have reflected the changed global climate. Platinum prices are 32% off recent peaks, while aluminium is down 21%, copper 26%, zinc 38%, nickel 48%, and steel 37%. Oil, a major import, is fortunately also 51% off its recent highs, which will help to support any recovery that takes place.

A further area of concern is increased risk aversion in international financial markets. This has already delayed government's privatisation drive, with the collapse in telecommunications shares preventing Telkom's IPO and the sale of government's stake in M-Cell. It has also helped to put considerable pressure on the rand, although this has so far helped to shield local exporters from the full brunt of the global downturn.

In short, South Africa is as dependent on the overriding question of whether the world faces a V- or

U-shaped recovery as other countries. A short, sharp recession followed by a strong recovery would be easily managed, with firm domestic spending compensating for weak export demand in the short term and stronger exports then ensuring the sustainability of the upswing. In this scenario equity markets represent excellent value, with the average historical price-earnings ratio at around 10. In contrast, a prolonged global downturn would lead at best to anaemic economic growth and markets that will tread water.

The jury is still out, but the potential for further accidents internationally is still high and consensus forecasts could well disappoint. A middle road, where the recovery is slower and weaker than the consensus expects, seems likely. In this base scenario, South African gdp growth would be under 2% in 2002, with household spending remaining relatively firm, but with export volumes easing and capital formation weak. Growth in excess of 3% would then become likely based on the recovery in the global economy in late 2002 and in 2003, as well as a more robust resumption in fixed investment spending.

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