



*The current world economic
crisis and its effects on South
African business*

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Introduction

Research Explanation

This research assignment refers to the list of financial market events which displayed a destabilizing of world economies that started at around the time of July 2007 and is currently still in play. This depression (or rather recession) in the world markets was initially tagged a “credit crunch” or a “credit crisis”. This names given the the current economic crisis explains what the issue was that originally led to the crisis and the now so tagged “credit crunch”.

This economic downturn has been ranked amongst the top in notable history. Economists are saying that this is the worst economic crisis / depression since the Great Depression in the late 1920’s which had a global effect.

International Overview

One of the main issues is that investor confidence was lost when the value of securitized mortgages in the United States resulted in a crisis in which there was great threats of liquidation which lead to a great growth in injection of capital¹ into the financial markets. This was done by the United States Federal Reserve, the Bank of England and the European Central Bank. This indicated to us that it was a problem that affects more than just the United States of America, it indicated that it is a global economic downturn.

In the September of 2008, things made a turn for the worse when the stock markets of the world began to “crash” and entered a time of insecurity. Many banks, mortgage lenders and insurance companies went bankrupt in the following weeks. One of the most publicized failures was that of the Lehman Brothers which filed for bankruptcy after many attempts to bail themselves out.

The crisis credit and banking crisis in the United States of America had a ripple effect with a global reach which affected the economic activities of many other countries. These affects are things such as the tightening of credit to consumers and corporations, steep declines in the world stock / securities markets, liquidity problems, increased public debt and the devaluation of some of currencies (specifically in the Icelandic crown, Eastern Europe and Latin America).

The housing market has come crashing down leaving developers in financial ruins as well as leaving people who bought house on credit in a huge problem - eviction. According to lowermybills.co.uk, Britons are in approximately £1.3 trillion in personal debt and it says that around 400, 000 people were not given mortgages in 2007 and the housing repossessions rose by 30% in the first six months in 2007.

In short, the blame is generally put on the United States sub prime home loans which they issued to borrowers who had poor credit ratings.

South African Overview

¹ “ a great growth in injection of capital.” - sudden forced increase of capital

South Africans and South African businesses have been affected by the global economic crisis. It is said that South Africans are approximately R1 trillion in personal debt. However, it is acknowledged that South Africans are not feeling the crunch to the same degree as the United States of America, Asia, Europe and Australia to name a few.

Much of this can be attributed to the National Credit Act which was passed in the March of 2006. The purpose of the act is;

“To promote a fair and non-discriminatory marketplace for access to consumer credit and for that purpose to provide for the general regulation of consumer credit and improved standards of consumer information; to promote black economic empowerment and ownership within the consumer credit industry; to prohibit certain unfair credit and credit-marketing practices; to promote responsible credit granting and use and for that purpose to prohibit reckless credit granting; to provide for debt re-organisation in cases of over-indebtedness; to regulate credit information; to provide for registration of credit bureaux, credit providers and debt counselling services; to establish national norms and standards relating to consumer credit; to promote a consistent enforcement framework relating to consumer credit; to establish the National Credit Regulator and the National Consumer Tribunal; to repeal the Usury Act, 1968, and the Credit Agreements Act, 1980; and to provide for related incidental matters”

According to the South African Publishers Association (SAPA), our Johannesburg Securities Exchange had been largely unaffected by the global economic crisis / credit crunch at the beginning of 2008. The source stated that this can be attributed to the fact that the “equities market of the JSE had a large commodity component”.

According to the Times 05 October 2008 article “SA’s credit crunch”, locals South African businesses have been holding sessions to decide as to how to deal with the daily effects of the economic crisis on business. The article suggests that local businesses are feeling the pain, but they warn that this is not the worst of the crisis.

For economic growth, the country needs foreign direct investment and due to the political uncertainty in South Africa (one of the reasons), investors have shied away from investments in South Africa. South African business (in general) states that even though it is becoming increasingly difficult to manage businesses, they are however holding onto the businesses long-term goals. They do admit that they may need to adjust their goals, but they will not totally abandon them.

“True individual freedom cannot exist without economic security and independence. People who are hungry and out of a job are the stuff of which dictatorships are made.”

Franklin. D. Roosevelt - 32nd President of the United States of America

How it began

As anyone who watched the 2008 American presidential elections would know, the credit crunch / economic crisis of 2008 is one of the most important issues for millions and millions of people.

Some like to compare the economic crisis to a storm that had been brewing for years. One of the main factors which led to the economic failure is market instability - the main aspect of which is the easily accessible credit which is blamed for drying up the flow of money and slowing economic growth which hindered the the trading of assets. It was made to easy for individuals to receive and apply for credit on which people bought houses and invested in other investments “based of pure speculation”

Many ask, how did it get so bad? The simple answer to such a question would be greed. Basically the entire of the American economy is built on debt, and according to the source, “credit is a great tool when used wisely”. Thousands upon thousands of people decided to take large loans that they could not afford in order to purchase a home in hope of selling it a making a large profit, however, we now see that this has had devastating effects for those who are unable to make the mortgage payments and even more devastating to those who are currently unemployment due to the lack of demand of goods and services in the market.

The housing slump (which is a characteristic of the previously mentioned problems) set of a chained reaction in the American economy and investors and individuals were unable to make the profit they had anticipated of the new homes they bought. People were unable to make their mortgage payments and this led to massive losses in the mortgage backed securities market. Due to this, the demand for housing dropped dramatically and housing developments slowed. People no longer wanted new homes and could not afford them.

Due to the fact that people were unable to make their mortgage payments, banks began to tighten their lending requirements and criteria. (It is important to note that South Africa’s National Credit Act has already been brought in in South Africa by this stage). If you think about it, banks need to loan money - its a large part of their business (they make interest from your loans), however when current debtors are not paying the bank, the bank slowly enters into a state of negative cash flow. For this reason, banks are not able to issue as many money through loans as have the cash backing.

As one author wrote, “credit in and of itself is not a bad thing. Credit promotes growth and jobs. Poor use of credit, however, can be catastrophic, which is what we are on the verge of seeing now.”

According to the facts, currently approximately 6% of all mortgage loans in the United States of America are in default. This means people are unable to pay back to loans. In the past, this number was only at around 0.25%. Most of these defaults come from sub-prime loans. Most of these loans were made to people who had poor credit ratings, no down payments of homes that were financed through banks.

Andrew Chen suggests that real estate booms are only bubbles that are created by irresponsible lending encouraged by banks. He also says that this boom has to bust and this has happened as we can see. The United States has ups and downs in the housing market (measured at approximately every 7 years.)

One question that one might ask is “why would banks make such risky loans?”. The answer is from government intervention in the market. The Clinton Administration put pressure on banks to help the poor to become homeowners. Banks were threatened by the government with lawsuits and fines to the value of \$10 000 per applicant that they “discriminated” against. ACORN which is Obama’s community service organization also played a huge role in the pressure put on the banks to give these poor people / disadvantaged people loans.

The original mortgage / loaning system is considered to be very good and sound. It required a down payment of 20% of the houses value to show their responsibility. Debtors were unable to make loans that exceeded 4 times what they made annually. Due to the fact that banks are now insured with large insurance companies against people who default, the bank is no longer in much risk against people defaulting, so they required a 0% down payment.

The Federal Reserve kept the interest rates in the United States artificially low and for this reason monthly mortgages were low and the housing market prices went up. Property was the “business” to be in - but unfortunately people got into this “business” backed by loans, that backfired when the housing market peaked in the winter of 2005 / 2006.

According to Andrew Chen, there are 3 main reasons as to why the economic crisis came about. He says that they are greed, inability of the government and the influence of academic society. In more simple terms one could place blame on the housing market in the United States and the irresponsible lending institutions of the United States (backed / forced by government regulation).



Source: The Telegraph (Financial Boards on the Cromwell Road, London)

Effects on International Markets

Nobody denies the fact that the rest of the world has experienced the “ripples” from the economic collapse in the United States that became ever stronger from late 2008. We have seen the collapse (not fully) of markets all over the world - America, Australia, Europe and Asia. The Bush Administration made a large mistake as argued by a economist at the Columbia University - Joseph Stiglitz. He says the following about the bill the legalized the bailout;

“I think it remains a very bad bill. It is a disappointment, but not a surprise, that the administration came up with a bill that is again based on trickle-down economics. You throw enough money at Wall Street, and some of it will trickle down to the rest of the economy. It’s like a patient suffering from giving a massive blood transfusion while there’s internal bleeding; it doesn’t do anything about the basic source of the hemorrhaging, the foreclosure problem. But that having been said, it is better than doing nothing, and hopefully after the election, we can repair the very many mistakes in it.”

In Europe and in the United States of America, we saw the government starting to nationalize the private industry - especially the lending / banking and motor industry. The United States Government spent billions of dollars on saving General Motors and Ford from going bankrupt in late 2008. The Bush Administration also announced that they would be buying shares in troubled banks in order to keep them open and operating. In total, the United States “handed” out about 700 billion dollars to industry in order to keep the economy afloat.

In Europe, many financial institutions failed and others are in serious need of aid. Some of the member countries of the European Union have also gone down the nationalization route in desperate attempts to save their economies. The Iceland economy relies heavily on their financial services sector, so for that reason, the economic crisis has hit their country hard. Countries that are in the development phase and third world phase are struggling from the rising costs of food and they are also being heavily effected by the every rising fuel costs. Developing countries are worried as they development aid from first world countries is uncertain.

Asia is becoming more and more worried about what has been happening in the west. In the public opinion, it is said that Asia is far enough removed from western economics. This is however false. Asia recently saw large economic growth. People in Asia became more wealthy, they invested their money in western investments.

This backfired as the western investments began a downward spiral. Another important aspect to look at is the international demand for Asian products. The western world before the economic crisis became so bad had a higher demand for Asian products than they do now during the economic crisis. This has a direct effect on Asian industry. This is an example of how the world is interconnected - especially in terms of economics.

According to Reuters, for once Africa’s lack of integration in the world economy may be in the best interest of Africa. They suggest that this may mean that Africa is not affected immediately by the economic crisis that has struck just about every other continent in the world. They do however say that the wealthier African countries may have less luck in this regard. The source suggests that in the long run Africa may experience a drop in foreign investment which will effect the development of these African countries. It also states that African countries may be pressured to pay back loans

that they had taken from first world countries as these countries will need the money back in their own economy.



Source: UPI (President José Manuel Barroso of the European Commission (EC), left, makes remarks as he and President Nicolas Sarkozy of France, who also serves as this year's rotating President of the European Union (EU), left, are welcomed to the Presidential Retreat by United States President George W. Bush, center, on Saturday, October 18, 2008. The two European leaders stopped at Camp David to meet with President Bush to discuss the economy on their way home from a summit in Canada to try to convince Bush to support a summit by year's end to try to reform the world financial system.)

How this relates to South African Business

As we can see from the previous sections, Africa and therefore, South Africa remains not as effected by the world crisis. This is not to say that we are not affected by it, but we have not been as badly hit as the rest of the world. We have two very good financial people in South Africa - namely Trevor Manuel (Finance Minister of South Africa) and Tito Mboweni (Governor of the Reserve Bank of South Africa.) Trevor Manuel has been the longest standing finance minister in the known history and has done fantastic work in the development of the South African economy.

According to a news source, the Johannesburg Securities Exchange which is based in Guateng was not heavily hit compared to other international stock / security exchanges within the first half of 2008. The JSE stated that "Volumes have continued to climb on the JSE while they have stagnated in certain world markets". This was attributed to the fact that the equities market of the Johannesburg Securities Exchange has had a large commodity component. What this mean is that we do not have a large financial services sector. So when we invest in the JSE, we are not investing in companies that have a main business focus of investing, but rather are companies that are providing physical goods and services - such as Pick 'n Pay or Checkers.

As far as the currency is concerned, the Rand fell again in the October of 2008 because the commodity prices and oil prices began to collapse. At the beginning of 2008, the Rand was at approximately 6.9 to the dollar and then at one point in 2008 it reached approximately 12 rands to the dollar.

The South African reserve bank has made preparations for small to medium economic shocks by building up a reserve to the tune of more than 30 billion dollars during times of strong capital inflows. The Herald Tribune however suggests that this will not be sufficient when South Africa is hit by a major economic crisis such as the current one we are currently experiencing.

According to Property Wire, owners of rental homes will be benefiting from the strong tourism industry that is becoming stronger and stronger despite the economic crisis. According to the official figures, the number of visitors to South Africa has increased around 9% since last year and this trend is expected to continue especially considering the fact that South Africa is hosting to 2010 Fifa World Cup.

According to analysts, or property market is expected to experience a medium strength downturn rather than a full of dive. This is backed by the statement made by Sizwe Nxedlana who is a property economist for Standard Bank. He says "Our analysis of the sources of the recession in the US housing market and its subsequent transmission to the rest of the US economy suggests that South African residential property will experience a relatively mild cyclical downturn rather than a full blown recession". This will have a large effect on Real Estate Agents / agencies (but not as bad as it could be if we had a full on property market recession) leaving many without employment and an income.

Even though South Africa was and is affected by the economic crisis, it has not stopped economic growth in the country altogether. In 2008, South Africa was home to the largest single foreign investment ever seen on the continent of Africa. China acquired a 20% stake in Standard Bank to the tune of R36 billion. The South African motor industry in South Africa had a reasonably good

year beginning with Fords South African branch announcing a plan to pump R1.5 billion into two of its South African plants. Volkswagen South Africa was soon after awarded a R12 billion export contract and for that reason the Volkswagen has confirmed a R3 billion revamp of their South African plant.

The United States (through the Overseas Private Investment Corporation) announced plans to make \$250 billion available in loans to South African business. Even though there seems to be so much positive news, the fear of unemployment still exists (especially considering the current unemployment rate in South Africa).

According to Shanta Devarajan who is the Chief Economist of the Africa Region at the World Bank says that we have problems such as unemployment, inequality, poverty and crime which continues to “plague” our country. This is naturally made worse by tough economic times. South Africa’s economy is heavily reliant on our primary sector. The demand for South African mining, agriculture and manufacturing outputs are on a decline. As discussed earlier, South Africans personal debt was at an alarming high of around R1 trillion at the end of 2008.



Source: Getty Images North America (U.S. President George W. Bush (R) shakes hands with British Prime Minister Gordon Brown (L) during their meeting in the Oval Office of the White House September 26, 2008 in Washington, DC. Bush met with Brown to discuss the global economic crisis.)

Suggested Solutions

Some might take the free market philosophy and apply it here and this suggests that the economy will sort itself out. These people believe that the market goes through cycles in which an economic crisis or recession will happen. However, they also believe that government intervention in the economy will lengthen the period that the economic crisis will last.

The other possible solution would be to setup a plan like the New Deal that Hoover and Roosevelt brought into action in America. This however would be at a huge cost to the economy of just about every involved country.

Paul Craig Roberts says that the government likes to think that the problem is defaulting mortgages. He makes a good point in suggesting that by bailing out the banks, it does not help the average person trying to pay of his or her debt. He suggests that rather than giving money to banks, the government should rather give it to the people struggling to pay off their debts. So he is suggesting that there is no clear link between the governments identified problems and the aid that they are attempting to provide.

I would suggest that governments stop bailing out private industry. It will result in large unemployment but will also lead to way for stronger businesses to emerge and in turn better outputs and also will provide a lot more employment opportunities. Governments need to focus on making sure that trade continues to happen between countries so that demand remains high and that will lead to higher consumption of the countries outputs.

South Africa (and most other developing countries) needs to promote international / foreign investment in the country. This will lead to economic growth and economic development of the country. As has been said by Trevor Manuel many times, South Africans need to pay of debts and also need to save more of their income for times of trouble or need in the future.

Considering the fact that mortgages seem to be the cause of most of these problems, I would think that it would be appropriate to instigate some new legislation to prevent the easy access to credit without a good credit rating / history and without a 20% down payment as done in the past before the Clinton administration.

Conclusion

In closing, I think that we can say that South Africa is affected by the economic crisis. We can also say that we have not been as badly affected as the United States of America, Europe, Asia or Australia. We can also say that South Africa was affected a lot later than the most of the rest of the world due to its strong economic policies pioneered by Trevor Manuel and his department. South African economic policies are currently being studied internationally to see what we did that has prevented such large scale economic chaos.

We can also take warning from the United States of America about credit and the easy access to credit. South Africans are in a n enormous amount of debt and if we are not careful, this could turn into a massive domestic economic problem. It is important that South Africans save larger percentages of their incomes, that way when economic troubles come, they will be able to support themselves.

As far as business goes, South African businesses are struggling. There are many things that are contributing to this struggle such as the cost of transportation, the demand of their production outputs and the high interest rates which affect businesses who are in debt. However, South African businesses say that they intend on staying inline with their long term goals. They do admit that they may need to adjust them, but that they will not totally abandon them.

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