T T Mboweni: Recent economic and financial developments

Address by Professor T T Mboweni, Governor of the South African Reserve Bank, at the University of South Africa, Pretoria, 23 August 2001.

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1. Introduction

Ladies and gentlemen, honoured guests. I wish to thank you for the honour you have bestowed on me by choosing me as the recipient of your award for Excellence in Managing the South African Financial Environment. In accepting this award and thanking you for extending it to me, I would like to make a few comments about the recent economic and financial developments in South Africa. I will touch on the recent price developments, the exchange rate, and developments in other emerging markets.

2. Recent economic developments

Towards the end of 2000 the South African economy had not been seriously affected by the world economic downturn. But by the first quarter of this year, it became clearer that we would probably be adversely affected by the slowing activity in the major world economies.

As we mentioned in our latest Quarterly Bulletin, published in June, the recorded decline in export volumes contributed to a slowing down in domestic growth from 3 per cent in the fourth quarter of last year to 2 per cent in the first quarter of this year. Although growth had already slowed from 4 per cent in the third quarter of 2000, the slowdown had largely been confined to the agricultural sector. But in the first quarter of this year, the weakness spread to other sectors of the economy. Of some worry is that the sector that bore the brunt of the slowdown was the manufacturing sector. The growth rate in this sector slowed from an annualised 4.5 per cent in the fourth quarter to a mere 1 per cent in the first quarter. This is somewhat puzzling because there appears to be strong demand for manufactured goods.

Domestic demand remained strong in the first quarter with household and government consumption expenditure rising and growth in real fixed capital formation and inventory investment accelerating. The welcome acceleration in inventory levels followed a steep drop in net inventory investment from the third to fourth quarters of 2000. This suggests that producers are positive about South Africa's future growth prospects and anticipate a sizeable increase in domestic demand.

3. Price developments

Inflation in the prices of consumer goods and services moderated meaningfully in the first half of 2001. The year-on-year rate of increase in the consumer price index for metropolitan and other urban areas excluding mortgage cost (CPIX) - the benchmark indicator for inflation-targeting purposes - has declined from 8.2 per cent in August 2000 to 6.4 per cent in July 2001. This rate of increase is only 0.4 percentage points above the upper limit of the inflation target range of between 3 and 6 per cent set for 2002. When measured from quarter to quarter and expressed at an annualised rate, the short-term pace of CPIX inflation has almost halved from 7.8 per cent in the first quarter of 2001 to 4.5 per cent in the second quarter.

"Headline" CPI inflation or the year-on-year rate of increase in the overall consumer price index for metropolitan areas slowed down from 7.8 per cent in February 2001 to 5.3 per cent in July.

Increases in the prices of consumer services decelerated quite significantly. In the case of housing-related services, price increases moderated from a year-on-year rate of 8.1 per cent in February 2001 to 2.8 per cent in July. Housing-related services include mortgage rates, house rent and domestic workers' wages. Expressed at a seasonally adjusted and annualised rate, the rate of increase in the prices of all consumer services fell from 13.4 per cent in the first quarter of 2001 to only 4.2 per cent in the second quarter. Smaller increases in the prices of other services, apart from housing-related services, also contributed to the decline in the inflation in the prices of all consumer services.

The year-on-year rate of increase in the prices of consumer goods fell back from 8.7 per cent in August 2000 to 5.2 per cent in July 2001. Declines in the price of food, which had risen steeply in 2000, helped to bring down the inflation rate.

In contrast to the moderation in consumer price inflation, production price inflation has advanced at a firmer pace in recent months. Measured over periods of twelve months, the rate of increase in the all-goods production price index rose from 8.1 per cent in April 2001 to 8.6 per cent in May, June and July.

The year-on-year rate of increase in the prices of domestically produced goods which had receded from 8.0 per cent in November 2000 to 6.9 per cent in April 2001, accelerated to 8.2 per cent in July. Rising food price inflation, though still at a modest level, contributed most to the pick-up in inflation in the prices of domestically produced goods.

The higher inflation in the prices of domestically produced goods has been partly offset by a deceleration in the rates of increase in the prices of imported goods in recent months. Imported inflation, when measured over periods of twelve months, declined from 15.0 per cent in December 2000 to 9.2 per cent in July 2001. The decline in imported inflation over this period was primarily due to lower international oil prices and the increase in the value of the rand in May and June 2001. Coupled with declining inflation in trading-partner countries, this contributed meaningfully to the slowdown in imported inflation.

4. Exchange rate developments

The performance of the rand/dollar exchange rate has been disappointing in recent times. It has traded between R8.01 on 4 July 2001 and R8.45 on 22 August. Whilst I have often said that commentators should focus on the trade-weighted value of the rand, as a deterioration in the value of the rand against the US dollar might merely reflect the strength of the US dollar on the international exchanges, the traded-weighted value of the rand has also succumbed to negative sentiment. It is currently around 8 per cent weaker than at the end of last year.

Why is the exchange rate of the rand currently under pressure? The reasons cited in the market are the following: in the first instance, currencies perceived to belong in the emerging markets asset class have been adversely affected by, in particular, developments in Argentina and Turkey. There are concerns in the market that, notwithstanding the official aid packages, with their accompanying conditionalities, Argentina's economic problems could prove difficult to resolve. Sentiment towards the rand has been clearly affected by fears of contagion.

Secondly, developments in Zimbabwe, in particular with respect to their land-reform programme, have also been cited as explanatory factors. The impact of these developments was compounded this week following a report on Bloomberg. Mr Thami KaPlaatjie, Secretary-General of the Pan-Africanist Congress of South Africa, reportedly supported Zimbabwe's approach to land reform and criticised those who oppose it as negating the interests of Africans. Furthermore, he reportedly also told journalists that the problem of land in South Africa will, when it explodes, be of enormous proportions - "too ghastly to contemplate" were his words. (I believe Mr KaPlaatjie was not speaking in his official capacity but, I must stress, the damage was done.)

I would like to repeat what I said yesterday at the Annual African Investment Conference held in Stellenbosch. I am concerned that developments in Zimbabwe have tended to have an adverse effect on our markets, in particular our currency and bond markets. I would like to reiterate that firstly, the land question in Zimbabwe needs to be resolved in accordance with the law and in an orderly fashion which finds a solution that is beneficial to the political and economic imperatives of Zimbabwe and the region.

Secondly, the current state of restlessness in Zimbabwe should really be brought to an end to allow the economies of Southern Africa to stabilise. Thirdly, our markets need to learn to differentiate between developments in one Southern African country and another. Here in South Africa the political leadership has consistently stated that land reform will take place according to the law as guided by the Constitution and the need for historical redress and food production. I hope the market players are listening to what is being said.

Fourthly, from the Reserve Bank's point of view we are highly appreciative of the efforts of the Southern African Development Community in trying to assist in a resolution of the Zimbabwean question. And finally, we should always be aware that the financial markets are affected by a multiplicity of factors, not just one factor. Since developments in one emerging market will from time to time affect another, it is therefore important that emerging markets design their policies and

programmes to receive the maximum benefit from globalisation. An "injury to one tends to be an injury to all".

The final factor which has been mentioned in the market has been the perceived increase in strike action and threatened labour unrest. Of course, the rand sometimes is pressurised by the perception that it is a "commodity currency", or concerns may emerge regarding the privatisation process in South Africa, or regarding the so-called NOFP, the net open foreign currency position of the Reserve Bank. Movements in the value of the rand can also, of course, be exacerbated by pure speculative trading activity in the foreign exchange market. Undoubtedly, however, the first three factors I mentioned earlier have dominated market sentiment and commentary in recent days.

I believe that the pressures on the rand are really, truly and honestly overdone. Cognisance has to be taken of South Africa's sound economic fundamentals to allay these contagion fears which might emerge if economic conditions in Argentina, Zimbabwe and Turkey deteriorate. Secondly, the South African Government has given a clear and unequivocal commitment to the rule of law and has recently been seen implementing court decisions without delay in respect of a land-occupation problem at Bredell. Fears regarding any land-reform programme in South Africa are unfounded. The best defence of a currency lies in the economic management of the country. South Africa pursues and will continue to pursue prudent macro-economic policies. I have no doubt that a carefully considered analysis of South Africa will lead to a retracement in the value of the rand's trade-weighted index.

5. Developments in other emerging markets

The increase of international financial transactions and international capital flows has brought with it an increase in the potential risks of a reversal. This sudden and large reversal of short-term capital flows has caused international financial crises in Mexico (1994-1995), Asia (1997-1998), Brazil (1998-1999) and more recently in Argentina and Turkey.

Argentina's economic performance deteriorated significantly from mid-1998 in the aftermath of the Asia, Brazil and Russia crises. After a short-lived pickup in the last quarter of 1999, the economy again stagnated in 2000. This reflected the fiscal tightening on domestic demand, a drop in business and consumer confidence, and the progressive hardening of financing conditions in international markets. The government responded with a strengthened growth-oriented economic strategy aimed at promoting and ensuring medium-term sustainability of the fiscal and external financial situations. It centred on a strong commitment by the government to reduce fiscal deficits.

The IMF supported this strengthened economic programme and increased Argentina's access to IMF financing in January this year. Argentina also received new loan commitments from other sources. Favourable developments that followed the agreement on the programme and financing package were interrupted in early March 2001 by a new crisis. The principle catalyst was evidence of a major deterioration in the fiscal performance, but internal political disagreements and increased uncertainty in international markets were contributing factors.

In June 2001, the government completed a nearly US$ 30 billion debt exchange with its major domestic and international creditors. Argentina's financial conditions improved somewhat but this proved to be temporary and Argentina's financial asset prices started falling in mid-July 2001 as analysts questioned Argentina's ability to meet payments on almost US$ 130 billion public debt. President Fernando De la Rua tried to reassure investors in July by announcing a series of strict measures to cut government spending and limit tax evasion. Argentina's stocks, however, fell sharply thereafter as investors questioned President De la Rua's proposed spending cuts and other economic measures designed to reduce Argentina's ballooning deficit. This package of measures, designed to achieve a zero fiscal deficit, was finally approved by Argentina's Congress at the end of July 2001 after much debate.

Fears of a regional crisis in Latin America, however, eased when Horst Kohler, the IMF's managing director, this week informed the Executive Board of the Fund that he was prepared to recommend an augmentation of Argentina's current stand-by credit facility by approximately US$ 8 billion to about US$ 22 billion.

Similarly, ***Turkey***'s economy experienced considerable growth since 1994 but had entered a recession by 1999 as a result of tight fiscal policies and the earlier Russian crisis. With high public deficits and a public sector making net payments of external debt after 1994, the pressure grew on Turkey's financial markets. The lack of depth of these financial markets and the volatile inflation rate

paved the way for sustained high real interest rates. The high real interest rate paid on domestic debt therefore increased the borrowing requirements of the public sector. All this created a vicious circle of debt and interest payments, pushing Turkey into an ever more difficult financial position.

The deterioration of the public financial balance, the rise in domestic debt due to continued high real interest rates, the acceleration of inflation rates and the continuing economic contraction made it necessary to embark on a medium-term economic austerity programme. This programme was designed to free Turkey from high inflation, restore macro-economic fundamentals and address structural weaknesses in the economy.

For most of 2000, the government’s economic programme made good progress. Consumer price inflation declined rapidly from 68.8 per cent in January 2000 to 33.4 per cent in February 2001, the lowest level since 1986. GNP growth also accelerated sharply from a contraction of 6.1 per cent in 1999 to an expansion of 6 per cent in 2000.

However, a severe banking crisis in late November 2000 was accompanied by a massive capital outflow. The crisis was triggered by liquidity problems in some medium-sized banks, which had positioned themselves aggressively for continued declines in interest rates. The underlying cause of the crisis, however, appears to be the significant deterioration in the current account and the delays in the privatisation programme which were causing interest rates to rise from September, and more markedly from around mid-November 2000.

The severe liquidity squeeze and growing bank distress was accompanied by pressure on overnight interest rates and government bond yields. The capital outflow was only halted, and devaluation fears allayed when the IMF announced in December 2000 an additional US$ 7 billion to alleviate the balance of payment difficulties stemming from the recent crisis. Interest rates declined and there was a modest rise in capital flows in January 2001.

In February 2001, a second financial crisis was triggered by a political dispute between Prime Minister Bulent Ecevit and President Ahmet Necdet Sezer. The dispute raised concern that the country’s three-party coalition government might collapse and raised doubts about the authorities’ commitment to reform. Market confidence in the system was shattered and the Turkish lira faced a fresh major attack in February 2001. The central bank spent US$ 4.5 billion, one sixth of its reserves, to defend the lira. These attempts, however, failed to restore confidence and the Turkish authorities decided on 22 February 2001 to allow the lira to float freely.

Turkey’s economic programme was again strengthened following the crisis that led to the floating of the lira. The new economic framework included increased transparency, accountability and good governance in both the private and public sectors. The improved programme aimed to strengthen the primary fiscal position of the public sector, reduce the government’s immediate borrowing requirement and address major bank restructuring. Market sentiment, however, again started to deteriorate in early July 2001 when the IMF postponed a portion of the Turkish loan. The differences between the IMF and the Turkish authorities were fortunately resolved and the IMF approved the eighth review of Turkey’s economic programme supported by the three-year Stand-By Arrangement on 12 July 2001.

The IMF’s Executive Board also completed the ninth review of Turkey’s economic programme on 3 August 2001. This decision will enable Turkey to draw an additional US$ 1.5 billion from the IMF. The IMF is convinced that there are encouraging signs that the economic downturn in Turkey is bottoming out, and that the targeted lowering of inflation is materialising, which could permit declines in interest rates. The IMF is also encouraged by the considerable progress in the structural reform agenda, especially in restructuring the banking system. However, the Turkish lira has again started to depreciate rapidly since the beginning of August as confidence in Turkey’s ability to repay US$ 26 billion of debt (before the end of this year) has been shaken by repeated disputes between members of the governing coalition. The Turkish authorities have also decided to formally make an inflation target the nominal anchor of Turkey’s monetary policy beginning in the fourth quarter of this year.

The effects of the Mexican, Asian and Russian crises spread from one country to another in a process commonly known as contagion. But in this case, the available evidence indicates no broad-based contagion from Argentina and Turkey to emerging markets in general at this stage. However, according to the IMF, the potential for broader-based contagion still remains. Concerns about Argentina did spill over into the region, notably to Brazil, which is also suffering from domestic difficulties.

I once again appeal to our markets to judge South Africa on its performance and not on the basis of emerging market perception.

And once again, my heartfelt thanks to you.