T T Mboweni: Recent economic developments in South Africa

Speech by Mr T T Mboweni, Governor of the South African Reserve Bank, at the Cape Times Business Breakfast, Cape Town, 20 May 2003.

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1. Introduction

Against the backdrop of a weak international economy, the salient recent economic developments in South Africa from the Reserve Bank's perspective are the promising trends in inflation, the slowdown in the pace of domestic economic activity and the behaviour of the exchange rate of the rand. Before we address these issues, however, we would like to briefly reiterate the Bank's mandate and our view of our role in the economic growth process.

According to the Constitution, the task of the Bank is to protect the value of the currency in the interest of balanced and sustained economic growth in the country. The overriding objective is therefore price stability, by which we mean achieving and maintaining a low and stable rate of inflation. Within the inflation targeting framework, we have been mandated by Government to achieve an inflation target of 3-6 per cent. Achieving low inflation is not an end in itself: it is important because it is a prerequisite to the growth process. Furthermore, from a welfare perspective, the distributional impacts of high and variable inflation are such that it is generally the poor that are hardest hit by inflation as they are the least able to protect themselves or hedge against this.

It is sometimes argued that by focusing on inflation we are not concerned about growth. As I have just stated, our longer-term concern is precisely with economic growth, employment creation and sustainable development. At issue then are short-term growth fluctuations. Although this is not our primary focus, it does not mean that we ignore cyclical movements. Most central banks, even inflation targeting central banks, are concerned with such fluctuations, but central banks may differ in terms of the weight they put on these fluctuations in their reaction function. Some central banks have a dual mandate and therefore have to focus more directly on cyclical growth whereas others, such as in our case, have a single mandate. It is also generally the case that in the early phase of inflation targeting, a greater weight is put on inflation as credibility is built up. Although inflation is our main objective, we are nevertheless sensitive to the real effects of our policy actions.

In any event, the current and particularly the expected state of the domestic economy is an important consideration in making monetary policy decisions. The state of domestic demand is an important determinant of inflation, so, although we may not be targeting short-term growth, our monetary policy is not set independently of such developments.

2. Inflation developments

As is now well known, the depreciation of the rand during the last quarter of 2001 resulted in a surge in inflation which prevented us from realising our inflation target for 2002. We had been well on course to achieving that target, with CPIX inflation having fallen below the 6 per cent level in September and October of 2001. Since November 2001, inflation accelerated and the average for 2002 was 10 per cent, 4 percentage points above the upper band of the inflation target. Fortunately CPIX inflation appears to have peaked in November of 2002 at 12,7 per cent. Since then we have seen a gradual decline, with rates of 11,3 per cent in February and 11,2 per cent in March. At these levels, we are still significantly far off from our inflation target of 3-6 per cent.

However, there are a number of pointers to a sharper decline in the inflation rate over the next few months. Firstly, the quarter-on-quarter figures which give a better indication of the short-term trends show that on an annualised basis CPIX decelerated from 14,5 per cent in the fourth quarter of 2002 to 6,7 per cent in the first quarter of 2003. What was particularly gratifying was that the main driver of inflation in 2002, food price inflation, fell steeply from an annualised rate of 18,7 per cent to only 2,4 per cent over the same period.

Secondly, to the extent that the Producer Price Index is an indicator of future consumer price inflation, the prognosis for a significant decline in CPIX inflation is good. The year-on-year all-goods PPI in March 2003 was down to 5,1 per cent, with a lot of impetus coming from the recovering exchange rate of the rand - the imported component of the CPI fell to 0,5 per cent, the lowest rate of increase since

May 1998. Measured quarter-to-quarter and annualised, these rates were even more encouraging with negative inflation being recorded. The all-goods PPI inflation was minus 3,6 per cent, while the imported component was minus 10,4 per cent.

Thirdly, the forecasting model of the SARB also indicates a sustained decline in CPIX inflation during the course of the year. However, a word of caution is necessary. As we have consistently emphasised, we conduct monetary policy on a forward-looking basis. What our forecasts show, as published in the most recent Monetary Policy Review, is that CPIX inflation is expected to bottom out to average around 5,7 per cent in 2004. These forecasts may of course be superseded by subsequent events, and we will be seeing the latest forecast at the forthcoming MPC meeting. However, most forecasts project a significant slowdown in the pace of at which inflation is expected to fall later in the year or early next year. Bearing in mind that we should be focusing not on the upper end of 6 per cent but more around the mid-point of the target range, even if the latest forecast turns out to be more optimistic with respect to the longer-term outlook, it is unlikely to move right down to the mid-point.

Finally, this outlook for inflation is also supported by recent monetary developments. The year-on-year growth rate of M3 decelerated from 12,8 per cent in December 2002 to reach 5,7 per cent in March 2003. The quarter-on-quarter seasonally adjusted and annualised growth rate in M3 decelerated from 6,9 per cent in the fourth quarter to 1,9 per cent in the first quarter of 2003. Similar trends have been observed in the growth rates of the narrower monetary aggregates as well. Growth in credit extension to the private sector from the monetary institutions was also subdued, although the figures were distorted by regulatory and accounting changes of a technical nature which came into effect from January 2003. Although private sector credit extension accelerated to twelve-month growth rates of 13,8 per cent in February and 16,6 per cent in March 2003, adjusting for the reporting changes, these growth rates would have been 9,1 and 9,3 per cent respectively.

3. Recent labour market developments

As our MPC statements have emphasised, there are a number of risks to the inflation outlook. One that is emphasised repeatedly is the trend of unit labour costs. In reviewing recent economic developments, we feel it is important to say something not only about unit labour costs, but also about some positive developments on the employment front. We often hear the criticism that inflation targeting is detrimental to growth and employment creation. However we wish to point out that these positive developments occurred within our inflation targeting framework. That is not to say that monetary policy should take credit for employment creation, but rather to illustrate the point that an inflation targeting framework is not necessarily an impediment to employment creation.

According to the *Survey of Employment and Earnings in Selected Industries* by Statistics South Africa, regularly surveyed formal non-agricultural employment rose in the each of the last three quarters of 2002. This resulted in employment gains of about 70,000 workers and follows three years of continuous decline. These positive developments occurred in both the private and public sectors of the economy. In both these sectors, employment rose at a rate of 1,2 per cent in the fourth quarter of 2002.

This turnaround in employment trends suggests that employment has begun to be responsive to economic growth and that the restructuring process that characterised the economy since the early 1990s is bearing fruit. The unemployment rate nevertheless remains high at 30 per cent, but there are encouraging signs that it is not increasing. Unemployment remains one of the main challenges facing South Africa and will be addressed at the planned Growth and Development Summit on 7 June 2003 between Government, Business and Labour. The summit will endeavour to formulate sectoral and developmental agreements that foster economic growth and job creation.

Although things are looking better on the employment front than they have done for a number of years, the concern for the Bank is the trend in unit labour cost, which plays an important role in the inflation process in South Africa. During 2002, wage settlements have trended higher, in response to the higher inflation. The slowdown in economy-wide productivity growth and rising nominal wage growth resulted in non-agricultural unit labour cost accelerating from a year-to-year rate of 4,1 per cent in 2001 to 7,0 per cent in 2002.

Central to our concern is the fact that wage settlements often tend to be set in a backward-looking manner, particularly in the case of multi-year agreements. This acts as a constraint on the downward movement of inflation and leads to so-called inflation persistence. There is evidence that not only wages, but also inflation expectations, are set in a backward-looking fashion. We would like to see wages (and prices) being set in a forward-looking manner, i.e. on the basis of the inflation rate that is expected to prevail over the period for which wages are being set. This will result in a lower sacrifice ratio i.e. the output cost of reducing inflation will be much lower if wages and prices are set in a forward-looking manner on the basis of the inflation target. Of course for this to happen, there has to be credibility that the Reserve Bank will be able to achieve the inflation target. This credibility can only be built up by the Bank achieving the inflation target and having a proven track record of maintaining low inflation. For this reason we are determined to achieve the inflation target. The benefits to the economy will not only be higher long-term growth, but also lower short-term output costs in reacting to unexpected shocks in the future.

There is also some evidence of backward-looking behaviour in the formation of inflation expectations. In the survey conducted for the Bank by the Bureau for Economic Research, for example, labour and business respondents in particular appear to adjust their expectations to follow actual inflation, with the expectation that these levels will be maintained over the next three years. If wages and prices are set on the basis of such expectations, inflation will remain higher and the job of monetary policy that much more difficult.

4. Domestic Output and Expenditure

Domestically, 2002 was a relatively good year for economic growth. Despite the slowdown in the international economy and the short-lived global recovery, South Africa's growth performance of 3 per cent in 2002 was relatively sound despite the tighter monetary policy stance adopted during the year.

However there are signs that economic activity is slowing down. The slowdown can be seen in the quarter-to-quarter annualised growth figures in 2002 which declined from 3,8 per cent in the second quarter to 2,4 per cent in the final quarter. The slowdown in the fourth quarter was mainly due to slower growth in the real value added by the secondary sectors and the fact that there was virtually no growth in the primary sectors of the economy. These sectors appear to have been affected by the recovery in the rand and the continued global slowdown.

Overall there was a robust increase of 4,1 per cent in manufacturing output during 2002, but this has tapered off significantly. The latest released data show that although growth between the first quarter of 2002 and the first quarter of 2003 was 0,4 per cent, quarter-on-quarter manufacturing production fell at a seasonally adjusted and annualised rate of 7,4 per cent in the first quarter of 2003. Other indicators, such as the latest Purchasing Managers Index also point to a slowdown in activity.

Although there appears to be some slowing down of the economy, there are indications that domestic final demand remains fairly strong. Despite the increase in interest rates over the past year, real growth in household consumption expenditure was unchanged from 2001 at 3,1 per cent although on a quarterly basis there was a decline over the year in durable goods consumption. Government consumption expenditure growth remained relatively strong and increased slightly.

From a future growth perspective, the promising aspect of the domestic expenditure growth is the increase in domestic capital formation. Gross fixed capital formation increased in successive quarters, reaching 11,5 per cent growth in the fourth quarter and 6,5 per cent for the year in 2002 compared to 3,2 per cent the previous year. Although part of this was due to the purchases of new aircraft by SAA, the expenditure related to Coega and other projects was also significant. Indications are that because the capital expenditure of all tiers of government is improving, there is greater capacity for delivery, and much-needed infrastructural expenditure is now taking place.

The weak international environment and the stronger rand have resulted in a deterioration in the trade account of the balance of payments, which is likely to be reflected in a less favourable current account than in the fourth quarter of 2002 when a surplus of R4,3 billion was recorded. The physical volume of merchandise exports declined by 5,3 per cent in the first quarter of 2003. This, together with a decline in prices of merchandise exports, resulted in the seasonally adjusted and annualised value of merchandise exports falling by approximately 13 per cent over the past quarter, from R295,9 billion in the fourth quarter of 2002 to R257,8 billion in the first quarter of this year. Net gold exports declined from R40,2 billion to R35,6 billion over the same period. The 10,8 per cent decline in imports was insufficient to offset the decline in exports, and this resulted in a contraction of the trade account surplus in the first quarter of 2003 to R32 billion, from R43,1 billion in the final quarter of 2002.

Looking at the market activity, the monthly average turnover on the JSE Securities Exchange SA (JSE) during the 12 months ending in April 2003 amounted to R75 billion. This was slightly higher than the monthly average for the preceding 12 months (R70 billion). The domestic equity market performed exceptionally well during the first five months of 2002, benefiting from the sound performance of the gold index. However, by the end of April this year, the monthly average share price level had fallen by 32 percent from its all-time high of 11 686 reached on 22 May 2002.

The turnover on the JSE increased from R55,8 billion in January 2002 to R104,2 billion in June 2002. In January 2003 turnover amounted to R61,8 billion, falling to R46,9 billion in April this year. The total annual turnover for 2002 also increased to R842 billion from R607 billion in 2001.

Since July 2002, foreign investors became large net sellers of domestic bonds and equities. A net amount of R5,6 billion worth of equities was sold during the calendar year 2002. This trend continued in January 2003, when R3 billion worth of equities was sold in that month. In February 2003, however, foreigners turned buyers of equities and they bought a net cumulative amount of R1,6 billion over the last four months. From the beginning of 2003 to mid-May non-residents sold shares to the value of R1 billion on a net basis.

Foreign holdings of domestic bonds also decreased substantially since July 2002. A net amount of R12,7 billion was sold by them over that period. During April 2003, a large net amount of R5,8 billion was bought by foreigners as the interest rate differential brought profitable opportunities to the foreign investors. From the beginning of 2003 to mid-May, non-residents were net buyers of bonds amounting to R1,5 billion.

5. International Economic Developments

South Africa's recent economic performance has to be seen against the backdrop of an international economy that continues to move at a sluggish pace. The expectations of an early recovery in the United States and the euro area have receded, and most analysts have downgraded their forecasts for world growth, particularly in the advanced economies. Given that the US is still the engine for world growth, this does not indicate that there will be a general world recovery very soon. The euro area is not seen as a viable alternative engine for growth, and first quarter growth in the region was around zero, with Germany, Italy and the Netherlands recording negative growth. The timing of the recovery is very uncertain, and the more pessimistic forecasts see a low growth scenario for at least another two years. Even the more optimistic forecasts, which see some recovery later this year, have had to continually push out the timing of the recovery against the initial expectation of a recovery in early 2002.

Adding to this sobering outlook is the uncertain effect that the outbreak of SARS will have not only on the Asian economies (which was the one region that was expected to show significant positive growth this year) but on the tourist industry world-wide. South Africa will not be immune to this fall-out, and there is already evidence of some decline in tourism, particularly from East Asia. Tourism has been one of the important growth areas of late in the South African economy and during January and February of this year, the number of visitors to South Africa increased by over 8 per cent, compared to the same period last year. This is despite an unfavourable tourist environment of slow global growth and increased fears of travelling.

But it is not only tourism that is negatively affected by the slow global growth. The decline in manufacturing output mentioned above is to a large extent a result of declining export volumes. Although part of that is no doubt attributable to the recovery of the rand, the decline in demand due to the global slowdown is significant.

The low growth, and in fact fears of deflation in some countries, does mean that we remain in a low inflation international environment, which will help to contain inflation domestically. Similarly, the near conclusion of the war in Iraq has meant that we have returned to a more orderly world oil market, and a major risk factor to our inflation targets has in fact receded.

6. NOFP and Exchange Rate Developments

The recent successful government bond issue of Euro 1,25 billion has allowed us to achieve our objective of expunging of the NOFP. The US dollar equivalent of this amount, which was received on 16 May, was delivered against outstanding forward commitments which effectively eliminated the outstanding net open foreign currency position (NOFP) of the Reserve Bank. The net open foreign currency position stood at US$1,2 billion as at the end of March 2003. The exact details of the impact of this, and other transactions, which took place during the month of April and May, will be released in accordance with the Reserve Bank's regular data releases to the market. The outstanding forward book on 30 March 2003 was US$6,6 billion.

Probably the most important reason for the Reserve Bank to further reduce the outstanding forward book, now that the NOFP has been eliminated, is to eliminate a source of instability in the South African economy. According to many observers the total elimination of the forward book may contribute to a more stable exchange rate of the rand over time.

As and when the forward book has been eliminated, the focus of the Bank will turn increasingly to managing the foreign exchange reserves. Whilst there are a number of reasons for managing foreign reserves more actively, the most obvious reason would be to earn income on foreign currency assets. A higher level of reserves tends to provide a higher degree of comfort to investors from a credit worthiness point of view, and experience has shown that during times of financial market crises, countries with higher reserves tend to be more resilient.

Partly because of these positive developments in the NOFP, the international ratings agency Standard and Poor's recently raised South Africa's long-term foreign currency ratings to BBB and a stable outlook. This follows the re-rating by Moody's of South Africa's outlook to positive. This agency cited improved government debt ratios, improved external liquidity, “careful” macroeconomic management and the reduction in the NOFP. Fitch had also previously upgraded South Africa's long-term foreign currency rating to BBB. These improved ratings have already assisted in reducing South Africa's cost of borrowing as seen in the recent government eurobond issue.

Of all the recent economic developments, the behaviour of the rand has perhaps attracted the most attention. After depreciating by 0,4 per cent during January 2003 on a weighted average basis, the rand appreciated by 8,2 per cent and 0,4 per cent respectively during February and March, resulting in an increase of 7,5 per cent from the end of December 2002 to the end of March 2003. This followed a 26 per cent appreciation for 2002 as a whole. The nominal effective exchange rate of the rand improved by a further 10,2 per cent during April. More recently however, there has been a sudden reversal and as of yesterday afternoon, the trade-weighted appreciation of the rand since the beginning of the year was just over 5 per cent.

Much has been said about the behaviour of the exchange rate over the past two years in particular. The fact that there was pressure to appoint a commission of enquiry into the rand's depreciation implies that there was no obvious reason for such a sharp move in the exchange rate and that the move was clearly overdone. Given that there was a significant overshoot, it is not surprising that there has been a significant recovery. Prior to the depreciation in 2001, there was not a general view that the rand was overvalued. If anything, the current fundamentals are in better shape than they were at that time, so it would not be surprising to see the rand making a strong recovery.

Although there can be no doubt that interest rate differentials have played a role in the recent strength of the rand, even market analysts are sharply divided as to the extent of this effect. On the one hand, the currency pessimists argue that it is all a question of interest rate differentials, and that once the Bank starts lowering interest rates, the rand will retrace its steps to significantly weaker levels. On the other hand, the currency optimists point to the fundamentals, and in particular commodity price developments, and argue that the rand is around 'fair value' levels, and that any interest rate reductions will have a marginal effect. Some go as far as to say that there is still substantial scope for further recovery of the rand.

Whatever the case may be, the Bank's focus is on the inflation target. The Bank does not have a view on the appropriate value of the rand. Obviously from an inflation perspective, a stronger rand is better than a weaker rand, but as we have emphasised on numerous occasions, it is not Bank policy to intervene in order to influence the level or direction of the exchange rate. What activity there has been was for normal portfolio purposes.

Although there are disagreements as to the appropriate level of the exchange rate, there is general consensus that the more important issue is the volatility of the exchange rate. The volatility observed over the past few months is clearly not healthy for the economy. The uncertainty caused by such movements makes investment and export planning extremely difficult. What may seem a profitable venture under one exchange rate scenario, may turn out to be totally unviable should the exchange rate change substantially. Unless the exchange rate is driven by the underlying fundamentals, trying to predict exchange rate movements can be extremely hazardous and adds to the riskiness of investment.

Although the expunging of the NOFP was expected to eliminate an important source of volatility in the exchange rate, volatility is however a fact of life for most emerging market economies. In a recent Bank for International Settlements study comparing the experience of 12 emerging market inflation targeters with that of six of their industrial country counterparts, it was found that emerging market economies tend to be relatively more exposed to exchange rate fluctuations for a range of structural and historical reasons. The study concludes however that 'in the longer run,…… improved inflation outcomes, consolidation of policy credibility and economic development can be expected to help reduce some of the vulnerabilities of emerging market economies'. In addition, the study argues that although exchange rate considerations pose a challenge to emerging market inflation targeters, the cost of exchange rate movements are not only of concern to emerging markets. Current experience in Europe and the United States reminds us that having to keep an eye on the exchange rate is also a fact of life in industrial economies, inflation-targeting or not.

7. Conclusion

With low or at best moderate growth forecasted in the United States, the euro area and Japan, exports cannot be counted on to continue to lead South African economic growth in the near term. South African exporters will have to focus on improving competitiveness through productivity enhancements. They cannot just rely on the exchange rate. The mining industry and other exporters are crucially important to the South African economy but so are the many industries that source inputs from abroad. The current slowdown observed in the manufacturing sector is not simply a question of a strong exchange rate, but also the weak state of global demand.

The bottom line for us at the Bank, however, is that our actions will be guided by the need to achieve our mandate. There are currently promising signs that the inflation rate is on a sustainable downward trajectory. However, monetary policy will be determined by how the Monetary Policy Committee sees the future course of the factors that determine inflation. These factors include not only the state of domestic demand or output, but also the extent to which unit labour costs and inflation expectations react to these factors. On the whole, the outlook for inflation looks good.

Thank you.