T T Mboweni: Recent economic developments and monetary policy in South Africa

Address by Mr T T Mboweni, Governor of the South African Reserve Bank, at the Mercury/Safmarine Business Breakfast, Durban, 14 May 2004.

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1. Introduction

Ladies and Gentlemen. Since September of 2003, monetary policy in South Africa has succeeded in maintaining CPIX inflation within the specified 3-6 per cent target range. This was achieved less than a year after inflation had peaked at over 11 per cent in November of 2002. This success was a result of the monetary policy reaction to the inflation surge in 2002 following the depreciation of the rand in late 2001, as well as other favourable developments, both domestically and internationally.

This morning I will review some of the recent economic developments, both positive and negative, that have contributed to the favourable inflation outcomes of the recent past. However monetary policy should not dwell on the past. Monetary policy should be, and in fact has been, forward looking, and I will, therefore, highlight some of the risks and challenges to monetary policy in the future.

2. International economic developments

After a number of false starts, the world economic recovery was well under way in the latter half of 2003, particularly in the United States and Asia. Real growth in the US had risen to 3,1 per cent in 2003, and the latest IMF World Economic Outlook forecast is for 4,6 per cent growth in 2004. The recovery has been accompanied by high levels of productivity growth, and more recently by increases in employment. The Japanese economy appears to have emerged from a protracted period of low or negative growth, and this has provided an additional stimulus to the Asian region. Recent suggestions of a possible slowdown in China have raised fears that the generalised recovery is under threat. This has had a negative impact on commodity prices in recent weeks. These fears are likely to be exaggerated, as China still has enormous growth potential. Although Chinese growth may decline from its unsustainably high levels, the country is likely to remain an important and dynamic engine of economic growth internationally.

Of greater concern to South Africa is the low growth in the euro area, South Africa's largest trading partner. Growth in the euro area was 0,4 per cent in 2003 and although there are encouraging signs that some of the countries in the region are beginning to recover, growth is only expected to reach 1,7 per cent in 2004. The United Kingdom, Latin America, Australasia and Africa have also been part of the global recovery to varying degrees.

Behind the euphoria, there are a number of factors that have been identified as posing a risk to the sustainability of the turnaround. Firstly there are the imbalances in the US economy. The US trade and current account deficits may require an adjustment in US macroeconomic policies, if the required adjustment is not achieved through movements in the dollar exchange rate. Some adjustment is inevitable as economic growth in the US accelerates. The challenge for the US will be to reverse its policies in such a way that does not undermine the global recovery and also achieves the desired effects with respect to the imbalances. The lenient macroeconomic policies of the United States in particular were an important element in bringing about the global recovery, and the challenge is to prevent the inevitable reversal of these policies from undermining the recovery. The recent positive employment figures emanating from the US have fuelled expectations that the tightening of the US policy stance will begin sooner rather than later. This will follow the lead of central banks in the UK, Australia and New Zealand which have already increased interest rates.

Secondly, a further risk to the global recovery is posed by the recent developments in the international oil market, where oil prices are moving inexorably towards the US$40 per barrel mark. This is a result of a combination of low inventory levels in the United States, the reduction in OPEC production quotas, tensions in the Middle East, and political problems in a number of oil-producing countries. As recently as February it appeared that the pressure on prices would be short-lived as the OPEC basket price moved from around US$30 per barrel down to the US$28 per barrel level, the upper limit of the OPEC target range. Unfortunately this turned out to be a temporary reprieve. The average price of the OPEC basket was US$32,05 in April and US$35,23 in the first week of May. Although at this point it appears that this threat is more short term in nature, there have been warnings that excessively high prices could undermine the sustainability of the global upswing.

Despite the upswing in the global economy, there is no widespread expectation of a revival of generalised world inflation. The IMF World Economic Outlook projects a decline in world inflation from 3,7 per cent in 2003 to 3,2 per cent in 2005. Although a handful of countries are expected to have higher inflation, the forecast is for all regions of the world to have single digit inflation by 2005. The expected upturn in the international interest rate cycle is likely to reinforce this positive inflation outlook, although the oil price developments could pose some risk.

Domestic economic developments

3. Output, expenditure and monetary conditions

Domestic growth has not been synchronised with world developments. Following the 3,6 per cent recorded in 2002, growth declined to an annual rate of 1,9 per cent in 2003, as a result of a significant contraction in the value added by agriculture and manufacturing. The poor performance in agriculture was a result of poor weather conditions that had an impact on both livestock and field crop production. In the case of manufacturing output, the contraction was largely a result of the initially slow world recovery and the impact of the recovery of the exchange rate of the rand. Capacity utilisation in manufacturing had declined in the fourth quarter of 2003 to 79,6 per cent.

There are, however, indications that South Africa’s growth prospects are improving. Although still at low levels, growth in the second half of 2003 exceeded that recorded during the previous six months and the recent good rains have improved the outlook for agriculture in many areas. The delay in the release of manufacturing sector statistics makes it difficult to know with certainty how the manufacturing sector has been performing in the recent past, but there are indications that there has been an overall improvement in this sector. Recent reports have pointed to strong domestic demand impacting positively on manufacturing, and various confidence indices as well as the Investec Purchasing Managers Index (PMI) are indicative of an improvement. There are also signs that the growth in world demand is beginning to have a positive impact on manufactured exports.

Domestic expenditure has continued to grow at a robust pace, increasing by 7,2 per cent in the fourth quarter on a quarterly annualised basis, and 4,2 per cent for 2003 as a whole, slightly lower than that recorded in the previous year. Gross fixed capital formation grew by 8,4 during the year, reflecting in part increased infrastructure spending by government, while government consumption expenditure and household consumption expenditure increased by 4,6 per cent and 3 per cent respectively. The latter was underpinned by declining prices of various consumer items, tax reductions, interest rate reductions, a declining ratio of debt servicing costs to disposable income and fairly high real wage settlements.

This excess of expenditure over output is reflected in a smaller trade surplus and higher current account deficit of around 1,8 per cent of GDP. Import volumes increased by 3,3 per cent in the final quarter of 2003 while the physical volume of exports of goods and services increased by 2,2 per cent. However, the trade surplus in February and March of this year improved as a result of an increase in exports with the 3-month moving average (seasonally adjusted and annualised) of the trade surplus increasing from R17,6 billion in January to R20,5 billion in February.

The moderate deficit on the current account is not an immediate cause for concern. At these levels the deficit is sustainable and has been comfortably financed through significant inflows on the financial account, which showed healthy surpluses in the final three quarters of 2003. The surplus in the final quarter amounted to R34,6 billion. However, there is no room for complacency. It is well known that financial account reversals can occur very quickly, and if expenditure growth proceeds unchecked, the current account developments could prove to be unsustainable.

The higher levels of domestic expenditure have been reflected in more buoyant money market conditions. Most of the money supply aggregates have grown at a relatively robust pace. The average twelve-month growth rate for M3 in 2003 was 13,0 per cent, and grew by 14,9 per cent and 14,0 per cent in February and March respectively. Twelve-month growth in banks' total loans and advances to the private sector has remained at levels of around 12,5 per cent since early 2003. Growth in mortgage, instalment sale and leasing finance has been particularly strong over the past year.

4. Recent labour market developments

The unemployment situation in South Africa remains a major source of concern. Fortunately, quarter-to-quarter increases in employment were recorded on both the public and private sectors during the final two quarters of 2003, reversing the trend of the previous two quarters.

From a monetary policy perspective, a concern of the Bank has been the trend in wage settlements, which play an important role in the inflation process in South Africa. Central to the Bank's concern is the fact that wage settlements often tend to be set in a backward-looking manner. This acts as a constraint of the downward movement of inflation. The Bank would like to see wages and prices being set on the basis of the inflation rate that is expected to prevail over the period for which wages are being set. Although wage demands are still trying to compensate for the high inflation of 2002, there are indications that nominal wage settlements, although still high, are moderating. According to Andrew Levy Employment Publications, the average rate of settlements in collective bargaining agreements declined from 8,9 per cent in 2003 to 7,6 per cent in the first quarter of 2004.

Of greater significance perhaps is the fact that the average unit labour cost increases amounted to 5,2 per cent in the fourth quarter of 2003 and an average of 5,0 per cent for the year. Although the trends are promising, the Monetary Policy Committee will be watching these developments carefully.

5. Exchange rate and foreign exchange reserves

The exchange rate continues to play a critical, albeit unpredictable role in the inflation process. During 2003 the rand continued its recovery and from the end of December 2002 to the end of April 2004 the nominal effective rand exchange rate appreciated by 16,4 per cent, and by 26,4 per cent bilaterally against the US dollar.

There are a number of factors that explain the recovery of the rand during the past two years. Besides the correction of the overshooting that occurred during 2001, other factors include US dollar weakness, rising commodity prices, positive interest rate differentials, improved perceptions of the strength of South Africa's economic fundamentals as evidenced by narrowing spreads on South African international bonds and improved credit ratings by the international credit-rating agencies. Furthermore, the conversion first of the net open foreign-currency position (NOFP) in May 2003 into a positive position, and the closing out of the Reserve Bank's oversold forward book during 2004 not only contributed to the rand's recovery, but is also expected to contribute to greater stability in the rand exchange rate, as the perception that the rand is a one-way bet has now disappeared.

In the past few weeks the rand has moved from the levels of around R6,50 to the US dollar to around US$7,00 to the dollar, a result of increased dollar strength, the recent moderation in commodity prices and an expectation of an early increase in US interest rates. In the past such a move would have sparked fears of a continuous depreciation of the currency, leading to a large sell-off. There is however a broader acceptance in the market that although the rand may still be subject to some volatility, a weakening of the currency will not inevitably lead to further weakening. The emerging view is that the rand will respond to changing fundamentals in an orderly manner, and the direction of change will not be one way. This change in perception is to a large extent a result of the improvement in the overall international liquidity position.

Although the Bank has been engaging in limited purchases of foreign exchange reserves for the purpose of bolstering foreign exchange reserves, this should not be misinterpreted as intervention in the market in order to target a specific level of the exchange rate. South Africa's foreign exchange reserves are low by comparison with other emerging market economies, and this perception makes the rand vulnerable to speculative attacks. The Bank's objective is to build up foreign exchange reserves in a prudent manner, and in such a way that has a minimum impact on the exchange rate. The Bank does not have a target for the exchange rate, and at this stage the Bank does not have a target for foreign exchange reserves or a target for the rate of accumulation of reserves.

As at the end of April 2004, gross reserves stood at US$10,1 billion while the net reserves or international liquidity position was US$6,4 billion. This can be compared, for example, to the position at the end of December 2002 when gross reserves amounted to US$7,8 billion and international liquidity position was minus US$1,6 billion.

6. Inflation developments

Developments on the inflation front continue to be positive. CPIX inflation slowed down from a peak of 11,3 per cent in October and November of 2002 to move to within the target range of 3-6 per cent by September of 2003 and has remained there since. It reached a low of 4,0 per cent in December 2003 before increasing to 4,8 per cent in February and then fell back to 4,4 per cent in March 2004. The achievement of bringing inflation down to within the target range can be attributed to a number of factors including the monetary policy response to the inflation shock of late 2001, positive base effects and the sustained recovery in the exchange rate of the rand. The decline in food price inflation, which had been a major factor driving inflation up in 2002, was also an important contributor to the decline in the inflation rate.

The upturn in the inflation trend in the early months of this year was not unexpected and in line with the Bank's inflation forecast. The Bank's inflation forecast which is published in the latest Monetary Policy Review, shows that CPIX inflation is expected to rise gradually towards the upper limit of the inflation target range before moderating again. There are a number of factors underlying this inflation outlook. On the positive side is the low world inflation, the relatively low levels of manufacturing capacity utilisation resulting in output below potential, continued fiscal prudence, and the impact of production price inflation, which is a short term indicator of future consumer inflation. Production price inflation has been negative since September 2003, with the rate of decline in the production price index slowing from minus 2,5 per cent in November 2003 to minus 1,0 per cent in February 2004 and minus 1,2 per cent in March. The main factor driving this trend has been imported prices, influenced by the recovery in the rand and the low global inflation. Imported price inflation has been negative since April 2003. However, domestic producer price inflation has also declined, reaching 0,2 per cent in November of last year, and 1,5 per cent in March 2004. On a quarter-on-quarter basis, producer price inflation showed no growth in the first quarter of 2004.

A further positive development has been the evolution of inflation expectations. The Bureau for Economic Research (BER) at the University of Stellenbosch conducts a survey of inflation expectations on behalf of the Bank. The latest survey released in April 2003 shows a continuation of the downward trend in CPIX inflation expectations. Most significantly, the expectations of business executives and trade union officials have fallen sharply.

Unfortunately there are a number of risks to the inflation outlook. A factor constraining the continued downward movement in the inflation rate was the fact that services inflation had remained relatively sticky. Services inflation did moderate from 8,6 per cent in September 2003 to 7,8 per cent in March, but this is still significantly above the upper limit of the target. A significant portion of services comprise administered prices which for long have been singled out as a threat to the inflation target. Fortunately some administered prices have shown signs of moderating, particularly in the light of low tariff increases granted by the relevant regulators to the Post Office, Eskom and Telkom.

A further concern is the trend in international oil prices discussed earlier. The higher international oil price translates itself quickly into higher pump prices and the effects have already been felt in the inflation numbers. The pump price of 93 octane petrol in Gauteng, for example, rose from R3,78 in January 2004 to its current level of R4,39 per litre, although this includes the 10 cents per litre increase in the fuel tax and the 5 cents per litre increase in the Road Accident Fund levy announced in the recent budget.

A lesser risk is posed by food prices which threatened to create problems as the maize price began to rise considerably in late 2003 as a result of the drought in large parts of the country. Fortunately this threat has dissipated somewhat with the good rains that were experienced in many parts of the country recently. The SAFEX futures price for white maize for delivery in 2004 increased sharply from around R1000 per ton in October-November 2003 to R1578 per ton early in February 2004. However prices have subsided to around R1100 per ton since March as rainfall figures improved late in the season and higher crop estimates were published.

7. Monetary policy

Recent monetary policy should be seen against the backdrop of the developments outlined above. Between June and December of 2003, the repo rate was reduced by 550 basis points, bringing the repo rate to 8,0 per cent, the lowest nominal level for this interest rate or its predecessor, the Bank rate, since 1980. However, historical comparisons of nominal rates can be misleading. In 1980 the inflation rate was around 14 per cent, implying a strongly negative real interest rate. Currently, although real interest rates have come down with the successive reductions in nominal rates, they are still significantly positive.

In December the repo rate was reduced by 50 basis points, despite the fact that the market consensus was that the reduction would be 100 basis points or more, with further reductions forecast for the subsequent meeting. It is perhaps important to explain why the MPC decision was not in line with market expectations. The expectation that the MPC would continue to lower interest rates aggressively in December was probably based on the incorrect assumption that monetary policy decisions are based on current inflation. At that time, CPIX inflation was within the target and was still trending downwards. However policy decisions are made not on the basis of the current inflation rate but on the basis of the expected trend of inflation over the control horizon, which is the lag between a change in monetary policy and its full impact on inflation. This transmission lag in South Africa is estimated to be between 18 and 24 months.

Monetary policy cannot impact on current inflation, rather it has to focus on future inflation. The current inflation rate is the basis for assessing the success or otherwise of past monetary policy. To assess the appropriateness of the current monetary policy *stance*, on the other hand, we need to look at how the expected trend of inflation over the next 18 to 24 months or so compares to the target.

In the same way that the decisions to lower interest rates during the course of 2003 were determined by the outlook for inflation rather than the actual inflation at the time, so the recent decisions of the Monetary Policy Committee to keep rates unchanged were based on forward-looking assessments of the factors that affect the inflation rate, and were informed by the forecasting model of the Bank. It should be stressed however that although the forecast is an important guide to policy, policy is not determined by the forecast in a mechanical way.

Although the current inflation rate was well within target at the time of the December meeting, the focus of the MPC was on the future trend of inflation. By then it was clear that a further lowering of interest rates, combined with the assessment of the factors that are likely to affect inflation in the future, would threaten the inflation target. These factors are likely to change over time, which is why there is a reassessment of monetary policy at regular intervals.

8. Conclusion

Over the past few months monetary policy has achieved the objective of keeping the CPIX inflation rate within the inflation target band of 3-6 per cent. Monetary policy was assisted in this through favourable developments that were outlined earlier. On the other hand, there are risks to inflation, and the Monetary Policy Committee will have to monitor these carefully. These risks include the uncertain trend in wage settlements, domestic demand conditions, and developments with respect to administered prices. Perhaps a more immediate threat is that posed by developments in international oil markets. Since the adoption of inflation targeting in South Africa, the economy has been hit by a number of shocks including food price shocks, exchange rate shocks and oil price shocks. Whilst the general policy prescription is to respond only to the second-round effects of such shocks, the challenge for monetary policy is to recognise when the impacts are becoming more generalised, and to act at the appropriate time to avoid undermining the integrity of the inflation targeting framework.

Thank you.