T T Mboweni: The South African economy: an overview

Address by Mr T T Mboweni, Governor of the South African Reserve Bank, at the School of Economics Awards Evening, University of Pretoria, Pretoria, 8 July 2004.

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World economic growth has gained momentum since the middle of last year and amounted to 3,9 per cent for 2003 as a whole. Early indications are that activity remained brisk in the first half of 2004, with China and India recording sparkling performances. The global economic recovery has created favourable conditions for higher commodity prices. However, consumer price inflation remained subdued in most parts of the world. Global inflation concerns has, however, arisen due to the relatively high price of crude oil. A number of central banks already pre-emptively raised interest rates moderately to contain future inflation, but on balance the level of short-term interest rates remains relatively low.

Favourable export prices, low interest rates and growth-supportive fiscal policy assisted domestic economic activity and South Africa has now experienced eighteen consecutive quarters of economic expansion. Growth in South Africa's real gross domestic product picked up decisively in the first quarter of 2004 to a seasonally adjusted annualised rate of 3 per cent - more than double the pace attained in any of the four quarters of 2003.

The acceleration in real output in the first quarter of 2004 was broad-based. Real output in important sectors of the economy such as manufacturing and agriculture, which had contracted throughout 2003, increased markedly in the first quarter of 2004. Platinum producers brought about an increase in the production of the mining sector, while construction activity expanded briskly and the tertiary sector again recorded a solid growth performance.

Preliminary indications for the second quarter of 2004 are that real manufacturing and mining production continued to increase.

In contrast to the acceleration in domestic production growth, the pace of expansion in real gross domestic expenditure lost some of its earlier momentum in the first quarter of 2004. This was largely due to a much slower pace of inventory accumulation than in the fourth quarter of 2003. The pace of growth in real expenditure nevertheless continued to exceed the pace of growth in real production.

Real fixed capital formation recorded an exceptionally high rate of increase in the first quarter of 2004 as private business enterprises stepped up fixed capital outlays and as the South African Airways acquired several aircraft. The increased production capacity flowing from investment expenditure gives good reason for optimism about future growth.

Growth in real household consumption expenditure also gained further momentum in the first quarter of 2004, supported by solid increases in households' real disposable income and lower interest rates. Tax reductions and relatively high wage settlements supported growth in real disposable income. Expenditure on durable and semi-durable goods increased at a brisk rate. Real government consumption expenditure also rose further mainly on account of the acquisition of another corvette.

Preliminary indications for the second quarter of 2004 are that growth in real gross domestic expenditure probably remained fairly strong. Solid consumer confidence and buoyant retail trade sales point towards this conclusion, as well as a quarter-on-quarter rate of increase of 3,6 per cent in new vehicle sales.

Formal non-agricultural employment declined at an annualised rate of 1,7 per cent in the first quarter of 2004. Both the public and private sectors experienced declines. Nominal remuneration per worker rose at a year-on-year rate of 9,4 per cent over the same period. Overall labour productivity increased at a year-on-year rate of 3,3 per cent in the first quarter of 2004 containing unit labour cost to a year-on-year rate of increase of 5,9 per cent.

Notwithstanding the recovery in world economic growth, the volume of South African exports contracted further in the first quarter of 2004. However, the value of exports increased on account of the marked improvement in the prices of South African export commodities. Import volumes also declined somewhat in the first quarter of 2004 because of a decrease in crude oil imported. Accordingly, the deficit on the current account of South Africa's balance of payments receded slightly to 1,6 per cent of gross domestic product. At this level it was easily financed by inflows of direct and portfolio investment.

Preliminary information for April and May 2004 indicates a possibly slightly weaker trade balance in the second quarter of 2004. However, in the second quarter of 2004 the proceeds from the Republic of South Africa's global bond issue of $1 billion supported investment flows into South Africa.

In the first half of 2004, the Reserve Bank continued its accumulation of foreign exchange reserves and the strengthening of its international liquidity position. The potential impact of these transactions on domestic money-market liquidity was sterilised by means of open-market operations.

The exchange rate of the rand against a basket of currencies strengthened by 16 per cent in the year ending December 2003 and, on balance, appreciated by a further 8,2 per cent in the six months to the end of June 2004. This appreciation occurred despite the setback to international prices of commodity exports in the second quarter of 2004 in response to indications that steps would be taken to cool down buoyant economic growth in China. While these movements of the exchange rate of the rand reduced the international competitiveness of South African producers, it resulted in a decline in the year-on-year change of imported goods over the past 14 months, notwithstanding a significant increase in the international price of crude oil over this period. Goods price inflation therefore moderated further both at the production and consumer level. By May 2004, CPIX inflation had been maintained within the 3 to 6 per cent target range for nine months in succession and the year-on-year rate of increase amounted to 4,4 per cent in each of the three months to May.

Twelve-month growth in M3 remained brisk though it decelerated from 12,6 per cent in April 2004 to 11,9 per cent in May. Credit extended by banks by means of mortgages, instalment sale and leasing advances to the domestic private sector recorded strong growth in 2004 under conditions of lower interest rates, rapidly increasing domestic expenditure and rising house prices. Growth in total loans and advances to the private sector nevertheless decelerated from 10 per cent in April 2004 to 9,1 per cent in May owing to a decline in overdrafts.

Yields on long-term South African government bonds increased sharply from 8,87 per cent on 17 January 2004 to 10,26 per cent on 15 June in response to the weaker exchange value of the rand and inflation concerns arising from strong real economic activity and the higher price of oil. Subsequently, bond yields fell back by about 50 basis points as the recovery in the external value of the rand scaled down inflation concerns. On balance, the trend in domestic yields closely followed that of US government bond yields from the beginning of March 2004. In the share market, prices on the JSE Securities Exchange SA fell back by 9,7 per cent from a recent peak in March 2004, in contrast to the bull rally in the preceding ten months. The real-estate market remained buoyant and house prices continued to increase at a brisk pace, recording nominal year-on-year rates of increase of around 24 per cent in the first half of 2004. However, month-on-month rates of increase in nominal house prices indicate that the prolonged boom in this sector could be losing some momentum in 2004.

The authorities continued to pursue a cautiously expansionary fiscal policy, recording a public-sector borrowing requirement of 3,2 per cent of gross domestic product in fiscal 2003/2004 - higher than before, but nevertheless in accordance with widely accepted principles of fiscal prudence. It is envisaged that this ratio will decline to 2,7 per cent in fiscal 2006/07. Rising capital expenditure by the public sector not only contributes to a more efficient functioning economy but public works programmes also enhance skills and create employment.

From this brief description of recent economic developments, it can be concluded that domestic growth prospects seem positive. The exchange value of the rand remains firm, and the improved foreign exchange reserve position could contribute to rand strength and stability. In general most factors favour a containment of inflation within the target range, and market participants also seem to be scaling down inflation expectations. However, in the short-term, developments in international oil prices, through their impact on domestic fuel costs, are likely to be a source of upward pressure on inflation and it is conceivable that the rate of increase in CPIX could temporarily breach the upper level of the target range towards the end of 2004 and the early part of 2005.

Forward-looking monetary policy remains focussed on the expected trend of inflation; policy decisions will be guided by the mandate to maintain CPIX inflation within the target range.

Collaboration between the Reserve Bank and universities

In conclusion I want to emphasise that the South African Reserve Bank has a vision of responsible and effective monetary policy formulation and continually strives to be an institution of excellence and innovation. In this regard, the Bank remains committed to capacity building and enhancing its skilled human resources, providing high-quality and relevant research, and facilitating and stimulating debate on pertinent monetary policy issues. I therefore wish to make use of this opportunity to emphasise the Bank's commitment to continuous interaction and involvement with the academic world on both theoretical and empirical aspects of economic research, monetary policy formulation and implementation.

As you are well aware, the Bank's professional staff members embark on a career at the Reserve Bank after obtaining formal qualifications from a university or other tertiary institution. Many of our staff members are encouraged to develop further skills and continue with postgraduate studies by utilising the bursary scheme of the Bank which is available to all our staff members. In fact, it makes me proud to see that tonight we are honouring no fewer than three of our employees who received their PhDs at the fall 2004 graduation ceremony of the University of Pretoria. They are joining the ranks of many other highly reputable senior bank officials who also obtained their postgraduate training at this illustrious university. I would furthermore like to add that the Bank supports human resources development in general and has now developed a new bursary system to support deserving students pursuing studies in economics, finance and ICT. These areas are central to our work at the Bank.

The collaboration between the Bank and the University of Pretoria has a proud history. I am therefore very keen that this close relationship be expanded further. This can be particularly beneficial for both our institutions in the field of monetary economics, which does not seem to receive enough attention in South Africa. Such a collaboration will be in line with developments elsewhere in the world. Internationally, establishing strategic partnerships between central banks and universities has become a norm. There is collaboration between the European Central Bank and the Goethe University in Frankfort and the Board of Governors of the Federal Reserve System and Georgetown University, to name just two.

I realise that the University of Pretoria, and particularly the Department of Economics, is already making a substantial contribution to training, research and policy analysis through the activities of the Bureau of Economic Policy and Analysis (BEPA), the Investment and Trade Policy Centre (ITPC), the Southern African Tax Institute (SATI) and the African Institute for Economic Modelling (Afrinem). Monetary economics, however, is perhaps not receiving the attention it deserves. This can perhaps be rectified in collaboration with the Reserve Bank.

Apart from the fact that the University of Pretoria is ideally situated in close proximity to the Bank, it stands to reason that formalising a partnership between the Bank and the University of Pretoria will create economies of scale to the benefit of both institutions. The interactions between the Reserve Bank and the University of Pretoria could play an important role in advancing our intellectual capabilities and the deepening of our knowledge regarding the intricacies of monetary economics in general and central banking in particular. The collaboration between the two institutions is therefore fundamental for the fulfilment of our commitment to excellence, not only in terms of training but also in terms of economic analysis and research.

I hope that our respective officials will finalise the proposal they are considering in this regard. I am absolutely excited about the potential for this.

Now, let me congratulate the Award winners tonight. Well done. We depend on you to research, write and publish on economic theory, empirical issues and inform on policy development.

Thank you.