T T Mboweni: Economic developments and monetary policy

Speech by Mr T T Mboweni, Governor of the South African Reserve Bank, at a dinner of The South African Institute of Electrical Engineers, Rand Club, Johannesburg, 22 July 2004.

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1. Introduction

Ladies and gentlemen, I thank you for the invitation to attend your dinner in these illustrious surroundings. It is indeed always an honour to attend a function at one of the oldest clubs in South Africa, and even more so because of the role that it played in the history of our country. I appreciate having the opportunity to talk to your Institute on this occasion because of your role in the development of our economy. As a topic for discussion I thought it may be useful to briefly look at recent economic developments in the world and in South Africa and conclude my address with a few remarks on monetary policy and exchange rates.

2. Global economic developments

The global economy started to recover at an accelerated pace during the course of 2003 and the first quarter of 2004 and then growth seems to have slowed down somewhat in the second quarter of this year. This was mainly due to slower growth in the United States and China. The softening in the economic growth of the United States' economy is probably a temporary phenomenon related to the spike in the international price of oil, which affects consumer expenditure. It is, however generally expected that business investment in the United States will pick up strongly in the second half of 2004 and give further impetus to the world economic recovery.

The slowdown in the Chinese economy was the result of deliberate policy actions taken by the Chinese authorities to cool down the rapid growth that they have experienced over the past years. Although the slower growth in China will occur from a very high level, it could have a significant impact on other Asian economies. A slowdown in China's energy, steel and chemical production could also affect demand in international commodity markets, resulting in a decline in international prices. China has become a major player in the world economy and is also now the fifth largest trading partner of South Africa.

However, it seems unlikely that this slower growth will be a lasting feature of the world economy and most international organisations such as the International Monetary Fund and the Bank for International Settlements are still projecting a marked recovery in the global economy in the rest of this year and in 2005.

Another important risk that the world economy is facing is the substantial increase in international oil prices. Brent crude oil prices have increased from levels around US$24 per barrel in May 2003 to almost US$40 per barrel in May 2004. This rise in international oil prices was mainly related to ongoing geopolitical tensions in the Middle East, together with a strong demand for oil in the United States and China. Although oil prices started to decline somewhat in June 2004 to levels of around US$34 per barrel when the OPEC countries indicated that they would increase their production, this did not last long and at present Brent crude oil prices are fluctuating again at around US$38 per barrel.

As one would expect with such a rise in oil prices, consumer price inflation increased in most of the major industrialised economies. For example, overall inflation in the United States accelerated from 1,7 percent in March 2004 to 3,3 percent in June 2004. These increases are, however, coming from low levels. A significant rise in global inflation is therefore not foreseen, particularly in view of continued strong productivity growth in some of these countries combined with a tightening in monetary policy stance.

After keeping the federal funds rate unchanged since the middle of 2003, the US Federal Open Market Committee raised this rate by 25 basis points to 1,25 percent on 30 June 2004. As underlying inflation is expected to remain low, the FOMC is of the view that “policy accommodation can be removed at a pace that is likely to be measured”. Such a tightening should therefore not be expected to have a marked impact on global economic growth. Several other central banks, including the Bank of England, the Reserve Bank of Australia and the Reserve Bank of New Zealand have also been increasing interest rates. By contrast the European Central Bank has kept rates unchanged, while monetary policy has been eased in Japan.

3. Domestic economic developments

An important side effect of the acceleration in the global economic recovery has been a strong growth in world trade and a sharp rise in international commodity prices. These factors have led to an acceleration in the export prices of South Africa, which together with the decline in domestic interest rates and a growth-supportive fiscal policy stance assisted the economy in maintaining a period of economic expansion that has now already lasted for eighteen consecutive quarters. During the course of 2003, economic growth in most of the main domestic economic sectors became a little hesitant, but it then picked up again decisively in the first quarter of 2004 when the real gross domestic product increased at a seasonally adjusted annualised rate of 3 percent - more than double the pace attained in any of the four quarters of 2003. Preliminary indications show a continuation of this relatively high overall growth in the second quarter of the year.

What made the strong growth in the first quarter of 2004 even more remarkable was that it was registered in all the main sectors of the economy. Real manufacturing and agricultural output, which had contracted throughout 2003, both rose at a seasonally adjusted and annualised rate of 2½ percent. Strong growth was also recorded in the value added by mining and electricity. Perhaps more important from the perspective of your Institute is that the real output of the construction sector continued to increase strongly. Its annualised quarter-to-quarter growth rate amounted to 6½ percent in the first quarter of 2004, the same rate as that attained in the fourth quarter of 2003.

The growth in real gross domestic expenditure continued to exceed the growth in real gross domestic product throughout 2003 and the first quarter of 2004 and probably remained strong in the second quarter. This strong growth in domestic expenditure contributed to the rise in domestic output and to a marked increase in the volume of imports. The demand for goods and services remained buoyant as a result of the significant reductions in the repo rate, decreases in income tax rates, high salary and wage settlements and the infrastructural expenditure of government and public corporations.

In particular, growth in real fixed capital formation accelerated considerably from the beginning of 2004. This follows on a good performance in 2003. The rate of increase in real fixed investment rose from 8½ percent in the fourth quarter of 2003 to no less than 21 percent in the first quarter of 2004. This exceptionally high growth was registered as a result of the fact that private business enterprises stepped up fixed capital outlays and the South African Airways purchased several aircraft.

Growth in real private consumption expenditure rose from an annualised rate of 4 percent in the fourth quarter of 2003 to 5 percent in the first quarter of 2004. The solid expansion in the consumption expenditure of households was discernible in all the main categories of expenditure, but was especially apparent in the expenditure on durable goods such as transport equipment, furniture and household appliances. The expenditure of households was influenced mainly by the continued growth in real disposable income, the reduced cost of credit, and an improvement in the net wealth of households related to the rise in house prices.

The real outlays on consumer goods and services by general government remained at a high level, particularly on account of the purchases of two corvettes for the South African Navy, while the pace of real inventory growth slowed down sharply in the first quarter of 2004 as the rebound in manufacturing production made inroads into stocks.

The continued expansion in economic activity at first seemed to have had the desired effect on employment creation and from 2002 onwards there were some quarters in which increases were recorded in the formal non-agricultural employment in the economy. On balance, employment creation in the non-agricultural sectors of the economy continued to be disappointing and it seems that the total number of persons employed declined in the current upward phase of the business cycle. The creation of employment opportunities will be crucial if we are to improve people's lives in the years ahead.

Considerably more success was achieved on the inflation front during the past year. The twelve month rate of increase in the CPIX declined from a recent peak of 11,3 percent in November 2002 to 4,0 percent in December 2003 and then rose to a still low 4,4 percent in May 2004. A number of factors have been identified in our Monetary Policy Statements explaining this favourable inflation outcome, which I won't repeat again this evening. It is generally expected that the high petrol and diesel price increases at the beginning of June 2004 and increases in the prices of medical products would have caused inflation to rise in that month. This should only be a temporary upward movement, which will probably again be reversed in the subsequent month. Projections using the SA Reserve Bank's econometric models indicate, however, that CPIX inflation could move above the upper boundary of the inflation target range towards the end of the year. Fortunately, this is also expected to be reversed relatively quickly and is not a significant cause for concern.

As already indicated, the increase in domestic expenditure led to a marked rise in the volume of imports during 2003. In the first quarter of 2004 the volume of imports contracted owing to a decline in the imports of oil. The volume of South African exports has fluctuated around a more or less horizontal trend since the second half of 2001, which brought about a substantial deterioration in the real trade balance over this period. This was accompanied by an improvement in the average terms of trade of 2½ percent in 2002, 4½ percent in 2003 and by a further 2½ percent in the first quarter of 2004 in comparison with the fourth quarter of 2003. These favourable price developments were unable to prevent the current account of the balance of payments from moving into a deficit. The improving terms of trade nevertheless kept the deficit on the current account of the balance of payments at a level of about 1½ percent of gross domestic product. At this level the current account was easily financed by net inflows of direct and portfolio investment.

As these inflows of capital exceeded the current account deficit, they led to a sharp increase in the gold and other foreign reserves of the country. The favourable overall balance of payments position also allowed the SA Reserve Bank to build up our official reserves to a higher level in a gradual manner while taking into account the limitations of our own balance sheet. As a consequence, the official gold and foreign exchange reserves of the Bank rose from US$7,8 billion at the end of 2002 to US$11,4 billion at the end of June 2004.

The authorities continued to pursue a moderately expansionary fiscal policy. The non-financial public-sector borrowing requirement as a ratio of gross domestic product accordingly rose from 1,4 percent in the fiscal year 2002/03 to a budgeted 3,1 percent in the fiscal year 2003/04. At this level this borrowing requirement is still in line with widely accepted principles of fiscal prudence. Moreover, it is envisaged that this ratio will decline in the coming years, despite the positive emphasis on infrastructural development.

On the monetary and financial fronts, the domestic economy was characterised by a few developments. Firstly, the twelve-month growth rate in the broadly defined money supply (M3) remained brisk throughout the last twelve months and fluctuated around a level of 12 percent. Secondly, credit extended by banks by means of mortgages, installment sale and leasing advances to the domestic private sector recorded strong growth in 2003 and the first half of 2004 under conditions of lower interest rates, rapidly increasing domestic expenditure and rising housing prices. Thirdly, money-market interest rates followed the repo rate downwards during 2003 and fluctuated around a horizontal trend in the first six months of 2004. Fourthly, yields on long-term government bonds, which had declined during 2003 to a low of 8,78 percent on 12 January 2004, rose to 10,26 percent on 15 June 2004 in response to rising inflation concerns. With the increase in the external value of the rand, yields fell again to below 10 percent in July. Fifthly, the JSE all-share index declined from an index value of 10387 at the end of December 2003 to 10131 on 21 July 2004 after having risen quite sharply from May 2003. Lastly, the real estate market remained buoyant and house prices continued to increase at a brisk pace, recording a year-on-year rate of increase of about 24 percent in the first half of 2004.

4. Monetary policy

As already indicated considerable success was achieved with the monetary policy measures during the past year and CPIX inflation has been within the target range since September 2003. This has allowed the SA Reserve Bank to keep the repo rate at an unchanged level of 8 percent per annum in 2004.

The major threats to the inflation target in this year have come mainly from exogenous factors. At first the drought experienced in the country was regarded as an important risk because of the negative implications that it could have had on food prices in general. Fortunately, this threat dissipated when widespread rains in February and March improved the outlook for the maize crop, leading to a fall in maize prices.

Increases in international oil prices then increasingly became the major negative factor for the inflation outlook. At the MPC meeting in April 2004, developments in nominal unit labour cost were also singled out as a risk to the inflation projection. The rate of increase of these costs declined from 6 percent in 2002 to 5 percent in 2003, but the salaries and wages per worker still increased at a rate of 8,7 percent. Other threats to the inflation outlook that were identified included the stronger trend in monetary growth, the rapid rise in domestic demand, and the threat of increased international instability.

These threats to the inflation outlook still exist today. However there are also many positive factors which should assist us in containing inflation in the coming months. The most important of these is perhaps the decline in inflation expectations. Other factors supporting a favourable inflation outcome are the strength in the external value of the rand, the decline in production prices, low expected world inflation, low levels of capacity utilisation and the fiscal discipline of government.

Against this background, our projections of inflation showed that the year-on-year rates of increase in the CPIX could temporarily breach the upper level of the target band towards the end of 2004 and early part of 2005. Any such breach is nevertheless expected to be short-lived, with the stronger likelihood that CPIX inflation would return to within the range shortly thereafter. The inflation outlook in general is still regarded as favourable. This view is supported by inflation expectations of business, labour, analysts and households.

In view of the success achieved with an inflation-targeting monetary policy framework, I find it surprising that so many people still seem to be very critical of this framework. This is probably related to the recent strength of the rand. Monetary policy and more particularly the inflation-targeting policy framework seems to have been singled out as being mainly responsible for this development. The rand's strength is, of course, not only dependant on monetary policy. In the current circumstances the weakness of the dollar and a substantial increase in international commodity prices contributed significantly to the strength in the external value of the rand. In addition, exporters have been selling their foreign exchange proceeds in an aggressive manner and South Africa has attracted considerable financial inflows owing to the improved macroeconomic fundamentals and confidence in our country.

The criticism against the monetary policy framework is even more surprising because the number of countries with floating exchange rates has increased dramatically since the early 1990s. This is partly due to the currency crises experienced under fixed exchange rate systems and a growing consensus on the disadvantages of conventional currency pegs. Floating exchange rates in combination with the inflation targeting regime have become the norm in a large number of countries, i.e. monetary policy has become more forward-looking while the determination of the exchange rate has been left to the currency markets.

Inflation targeting requires assessing all the available information, including real economic developments, monetary analysis and the external balance of the economy. This is done in a systematic and complex way. It is hence more demanding from this point of view than the alternative monetary strategies. Inflation targeting has placed the forecasting process at the heart of monetary policy decision-making. The inflation forecast has become not only an important internal decision-making tool, but also a crucial communication device. However, in line with best international practice, even our highly developed, technically advanced and well-organised forecasting procedure is certainly not an automatic pilot for monetary policy decision-making. The forecast is an important input into the monetary policy process and like other central banks we continue to try our best to continuously improve our macroeconomic forecasting capability. However, eventually the decision is always still based not only on the central forecast itself, but also on the assessment of all the associated risks.

We now have more than four years of experience with inflation targeting and although the new monetary policy framework was introduced in February 2000 in a challenging situation of not having all the required supporting systems properly in place at the time, the economy urgently needed a new and more reliable nominal anchor to ensure a sustained disinflation path. The first years of the new regime have certainly not been easy, and have been characterised by unfavourable currency developments that contributed to numerical inflation target misses. South Africa has nevertheless for some time now been experiencing inflation within the target range and surveys indicate clearly that inflation expectations are more firmly anchored at lower levels. It is now more important than ever for us to stay the course as continued price stability is the most crucial pre-requisite for sustained economic growth and development in the years ahead.

5. Exchange rate developments

The exchange rate of the rand against a basket of currencies recovered by 16 percent in the year to the end of December 2003 and, on balance, appreciated by a further 12 percent in the six-and-a-half-month period to the middle of July 2004, despite the temporary setback to the international prices of commodity exports in the second quarter. While these movements of the exchange rate of the rand reduced the international competitiveness of South African producers, it also caused the prices of imported goods to record twelve-month declines over the past 14 months, notwithstanding a significant increase in the international price of crude oil over this period. Goods price inflation was accordingly moderated, both at the production and consumer level, contributing to a reduction in twelve-month CPIX inflation.

Despite the fact that the rand is at a five-year peak to the dollar, prospects for the economy have continued to improve. Tourism has fared better than expected and manufacturing output has improved significantly. The trade sector in particular is thriving, consumer confidence is at record levels and the world growth outlook remains favourable, with the result that some analysts have announced upward revisions to their real growth forecasts for the South African economy for 2004 and 2005. This, together with indications of a possibly more favourable credit rating for the country, flies in the face of the projections of most doomsayers. The process of dealing with a strong currency has most certainly been painful but also beneficial as it has forced productivity improvements and increased competition in the economy.

Although business leaders continue warning of eroding profits and impending cuts in investment and jobs, the local economy has been adjusting well to a stronger, more stable currency. Significant problems have certainly been experienced by many mining and manufacturing enterprises as a result of the strength of the rand. This has had serious repercussions for the profitability of these enterprises, as well as their investment planning and employment. The recovery in the exchange rate of the rand has, however, forced companies to restructure their firms to cushion the impact of the strengthening rand. The restructuring has contributed to increasing resilience of the South African economy. Besides restructuring, the manufacturing sector has been taking advantage of buoyant domestic demand sparked by the sharp fall in interest rates last year to the lowest levels in almost two decades. Manufacturing enterprises have been taking advantage of strong local demand and are now doing this on a more productive basis as a result of restructuring. This has led to a rebound in manufacturing output from the first quarter of this year, and some analysts say this illustrates clearly that there were also benefits associated with the strengthening of the rand. Benefits that could last for a long time, rather than the short-lived relief of external price adjustments.

6. Conclusion

Critics of our current policy seem to forget these positive developments associated with the recovery in the exchange rate of the rand. I realise, of course, that there have been serious disadvantages, but I must emphasise that the strength of our currency is not directly related to the monetary policy framework that we apply. We accordingly still belief that an inflation-targeting monetary policy framework allows an independent central bank to commit credibly to its long-term goal of price stability. In such a framework supply and demand in the foreign exchange market must inevitably determine the level of the exchange rate of the rand. The role of the SA Reserve Bank in this framework is to gradually build up the official foreign reserves of the country to a respectable level in an orderly fashion in accordance with our balance sheet whenever circumstances allow us to do this.

So the state of the economy looks promising.

Thank you.