T T Mboweni: The South African Reserve Bank and gold; recent economic developments in South Africa

Keynote address by Mr T T Mboweni, Governor of the South African Reserve Bank, at the LBMA Precious Metals Conference, Johannesburg, 14 November 2005.

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Ladies and gentlemen, honoured guests.

1. Introduction

Thank you very much for inviting me to participate in this your annual conference being held here in South Africa this time. It is indeed a privilege and an honour to speak to you today. It is also fitting that a conference such as this one is held in Johannesburg. This city was born in 1886 and built on the gold mining industry which flourished as a result of the great mineral wealth present in the rock below us.

The African people refer to this place as Egoli or Gauteng which means the city of gold. The platinum group metals (PGMs) also play an extremely important role in the South African economy with South Africa being the major supplier of precious metals to the international market. Our role in the gold refining industry is also significant. The Rand Refinery is the world's largest single-site gold refinery and it refines gold from as far afield as East and West Africa and Latin America. Since the Rand Refinery was established in 1920 it has refined approximately 32 per cent of all gold produced globally. This is yet another good reason to hold this prestigious conference here.

So welcome, once again, to our 119-year old city. We can guarantee great weather and, to add to the excitement, some volatility in asset prices! Regrettably there is no guarantee as to the precious metals prices, either in dollar or rand terms, but we have certainly appreciated the recent upward trend in their dollar prices. I will leave it to you the experts to ponder the future path of these metals. Once you have done so and once you have sampled the delights that this country has to offer you as business people, we hope that you will return and sample its diverse offerings as a tourist.

2. The precious metals industry in South Africa

The precious metals market in South Africa has experienced significant changes in recent times. Exports of gold have receded from 51,0 per cent of total visible exports in 1980 to 9,4 per cent in 2004. Over the same period the platinum group metals exports have risen from 5,0 per cent to 9,0 per cent of total visible exports. The changing fortunes of these sectors were also reflected in employment: the number of jobs in gold mining receded from 476 000 in 1980 to 175 000 in 2004, while in platinum mining it roughly doubled from 77 000 to 151 000 over the same period.

Over the past decade, the contribution of gold mining to total gross domestic product declined from 3,2 per cent in 1994 to 1,5 per cent last year. At the same time platinum mining's contribution rose from 2,0 per cent in 1994 to 2,3 per cent in 2004. For all mining sectorscombined, the share in the total value added to the economy receded from 9,5 per cent in 1994 to 7,3 per cent last year.

More recently, Chamber of Mines data indicate that South African gold production in the second quarter of 2005 fell by 2,4 per cent from the first quarter and by 18 per cent year-on-year. These declines reflect the industry's adjustments to the current economic environment and the restructuring that has occurred over the past three years. Although the substantial increase in restructuring costs has resulted in losses for the industry, given that most of the restructuring has taken place, the Chamber of Mines expects the associated costs to decline going forward. This is a welcome development indeed.

The exchange rate is often seen as a source of the mining sector's difficulties. The necessity to adapt to these new and changing circumstances has impacted not only on the mining sector but on all exporting sectors. Despite the mining sector's difficult circumstances, South Africa remains the world's largest producer of gold and platinum.

3. The South African Reserve Bank and gold

The South African Reserve Bank has historically been an active participant in the gold market. Originally all newly-mined gold had to be offered for sale to the Bank within 30 days of production. Subsequently the Chamber of Mines negotiated the right to sell South African gold independently of the Bank in beneficiated forms of one kilogram and less. These direct sales were restricted to one-third of the annual production.

After lengthy consultation, a sea-change in these arrangements occurred when the Minister of Finance announced on 12 December 1997, in a further relaxation of Exchange Control Regulations, that South African gold producers may elect to sell their total output provided the Bank had given the necessary exemption from the relevant Exchange Control Regulations.

This led to a gradual but dramatic decline in the Bank's transactions in the bullion market. Notwithstanding this, the Bank continues to be keenly interested in the health of the bullion market. This is by virtue of South Africa's significant gold reserves both in the vaults and underground.

The SARB also remains active in the various forums where the issue of central gold reserves management is explored. The most prominent of these forums is organized from time to time during the annual meeting of the World Economic Forum in Davos, Switzerland, where producers and central banks discuss the prospects for gold.

The general impression that we have gained from these discussions is that the significant central banks which hold gold are very conscious of the impact that their gold sales programme have on the gold price and as such would not want to disrupt the market or cause unnecessary price volatility. The Swiss central bank for example has handled their gold sales in a transparent, honest and exemplary manner. Their programme was pre-announced and followed to the end accordingly.

There is some uncertainty however about what would happen in Germany when the new government starts to function. We can only hope that the current approach adopted by the Bundesbank will continue.

So the prospects for gold from a central bank perspective is good.

A colleague of mine is participating in one of the panel discussions scheduled for tomorrow and he will enlighten you on the Bank's management of gold reserves. But, allow me to make the following brief comments. The Bank holds around 4 million fine ounces of gold in its foreign reserves. It has held this net figure stable for the past number of years. Gold is, obviously, an internationally acceptable reserve asset. The Bank is very comfortable holding these gold reserves because of the metal's war-chest qualities,[1] because gold is no-one's liability, and because it allows prudent diversification in the Bank's total reserves. Whilst not being a signatory to the Central Bank Gold Agreement, we abide by the spirit of this Agreement in the management of the Bank's gold reserves. As I have mentioned, we are very satisfied with the level of our gold holdings. Indeed, as part of our reviews on the composition of total reserves, we may even consider increasing our gold holdings.

4. Recent economic developments

The South African economy has been in an upswing since September 1999, making it the longest business cycle expansion phase on record. During this upswing growth in real gross domestic product has averaged approximately 3½ per cent per annum. Recent data indicate that the sustained growth in real production is also being reflected in some very welcome gains in employment, although the unemployment rate of 26½ per cent remains very high and its further reduction a strategic imperative. Annualised growth in real gross domestic product accelerated from 3,5 per cent in the first quarter of 2005 to 4,8 per cent in the second quarter, with firm growth recorded in virtually all the main sectors of

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[1] Alan Greenspan in his testimony to Congress on 3 November 2005 said: "The bottom line is that in periods of extreme chaos, it's turned out that gold has been the ultimate means by which transactions have been consummated. It occurred, for example, during World War II that you could only negotiate transactions with gold."

the economy. All the final demand components – household consumption, government consumption, and fixed capital formation – have been expanding briskly.

As could be expected, the upswing in economic activity and expenditure was accompanied by a strong increase in import volumes. Accordingly, the current account of the balance of payments moved into deficit from 2003. The current-account deficit amounted to approximately 3½ per cent of gross domestic product in the first half of 2005. Information on visible foreign trade suggests a larger trade deficit in the third quarter of 2005 than in the first two quarters of the year, but comprehensive data on services and income flows for the third quarter still need to be finalised before the current-account balance for the third quarter of the year can be determined. Relatively favourable prices for most of South Africa's export commodities have been helping to contain the trade and current-account deficits. At the same time sizeable inflows of financial capital have been recorded over the past three years, exceeding the current-account deficits and enabling the Bank to increase its foreign exchange reserves.

On a trade-weighted basis, the rand appreciated by 11,7 per cent in 2004. During the first 10 months of this year it has depreciated by 9 per cent. The rand's overall recovery since the lows of late 2001 can be mainly attributed to improved perceptions about South Africa's economic fundamentals, US dollar weakness, rising commodity prices, positive interest rate differentials, and, of course, a recovery from heavily oversold levels. The emerging view of the rand is that it will respond to changing fundamentals in an orderly manner.

Rising income levels, improved confidence and lower interest rates have bolstered credit extension, resulting in banks' loans and advances to the domestic private sector increasing by 21,5 per cent over the twelve months to September 2005. Mortgage lending has been exceptionally strong, supported by rising property prices. Average house prices rose by more than 15 per cent over the past twelve months. However, this is already significantly slower than the 35-percent peak rate of increase recorded approximately a year ago. As a counterpart to the increases in bank loans and advances, the monetary aggregates have also been rising briskly. Twelve-month growth in the broad money supply, M3, amounted to 16,7 per cent in September 2005.

Share prices reached successive new record highs during the course of 2005, and the buoyancy in the share market was also reflected in record turnovers of shares on the JSE Limited in recent months. Non-residents are taking a keen interest in South African shares, and are increasingly involved in sizeable direct investment into South Africa. The operations of the financial markets have continued to grow over the years. The turnover in the equity market has risen from R62 billion in 1994 to R1 031 billion last year. Similarly, the turnover in the bond market has risen from R2 trillion in 1995 to R9,5 trillion last year. Improvements made to the JSE such as electronic clearing and settlement and the dematerialisation of shares and electronic trading has facilitated these developments. South Africa has also made progress in providing access to finance and banking activities to small and micro enterprises and the underbanked communities.

Fiscal policy has been disciplined over the past decade, contributing to the stable macroeconomic environment. Latest estimates provide for a national government deficit before borrowing of approximately 1 per cent of gross domestic product in the current fiscal year, while the government debt as percentage of gross domestic product has been brought down to around 36 per cent.

The inflation-targeting monetary policy framework adopted in February 2000 has contributed to the reduction of inflation to low levels, and has allowed for nominal interest rates to fall to levels last seen at the beginning of the 1980s. Real interest rates have also fallen and become less variable. For the past 25 months, CPIX inflation (i.e. headline inflation excluding mortgage interest cost) has remained within the target range of 3-6 per cent, despite strong output and expenditure growth in the economy.

Although currently we still expect inflation to remain within the target range, the outlook has been clouded by the increased risk posed by the behaviour of international crude oil prices which have more or less doubled in US dollar terms over the past two years. Domestic petrol prices have consequently increased and have recently resulted in a significant upward movement in CPIX inflation, from 3,5 per cent in June, to 4,8 per cent in August, although they fell back to 4,7 per cent the following month. Because monetary policy reacts with a lag, there is little that can be done about these so-called first-round effects. However we have to be vigilant to the possible second-round effects or more broad-based increases in inflation which come about when prices are raised in expectation of a generalised price spiral induced by the higher petrol prices. These expectations are affected to a significant degree by expectations of the Bank's policy reponses to the increases. In other words, the credibility of monetary policy is key.

In such a situation, monetary policy is faced with a dilemma, and indeed this is the dilemma faced by the MPC at present. At this point, there are few signs of second-round effects, and CPIX inflation excluding the first-round effects of the petrol prices increases, has remained remarkably stable over the past year. On the one hand, if no second-round effects emanate, monetary tightening could be unnecessary. On the other hand, if these second-round effects are expected to materialise, because of the lags in monetary policy, it would be appropriate to act sooner rather than later, to avoid being behind the curve. The challenge is to identify or anticipate these second-round pressures in advance. Monetary policy therefore has the difficult task of weighing up the risk of taking potentially unnecessary or incorrect action by being too preemptive, against the cost of delaying too long before taking action. This requires fine judgement on the part of the Committee.

The Bank will, in general, continue to accumulate foreign exchange reserves at a moderate pace and at opportune times. The gross reserves have already reached a level of nearly USD20 billion at the end of October 2005. While there has been a focus on steadily accumulating reserves, given their relatively low level compared to our peers, it must be remembered that we do not target a specific level of reserves. The improved level of reserves is expected to enhance exchange rate stability and improve the Bank's credibility.

Partly due to the strengthening of our reserves position, South Africa's credit ratings continue to be upgraded. In January this year, Moody's upgraded the country's credit rating from Baa2 to Baa1 with a stable outlook. This upgrade was based on the "substantial strengthening" in the country's foreign reserves position. Political stability and robust macroeconomic policies also played a role. Just recently, at the beginning of August, Standard & Poor's upgraded South Africa's credit rating to BBB+ to match the Moody's rating of Baa1, awarded in January 2005. Towards the end of August 2005 Fitch, similarly, revised South Africa's BBB rating to BBB+. These ratings place South Africa at the top of the lower investment grade band and are an endorsement of the country's economic fundamentals and policies. These upgrades have contributed to the increasingly narrow margins paid on the country's foreign borrowing.

The Bank will continue to encourage foreign direct investment. The advantages of FDI should not primarily be seen in terms of foreign exchange flows but rather for the benefits of technology and skills transfer, employment creation and enhanced international linkages.

We must continue to ensure an efficient payments and settlement system. Without this you cannot have an efficiently functioning economy. The National Payment System (NPS) is a vital element of financial stability and the Bank continues to enhance its safety and soundness by developing payment system oversight capacity and by maintaining a high standard in the provision of interbank settlement services.

We reached an important milestone in December 2004 when the rand was included in the Continuous Linked Settlement (CLS) system. The rand is now positioned as one of only 15 settlement currencies in the CLS mechanism. CLS is a world-wide industry initiative to reduce the risks associated with foreign exchange transactions by settling the two legs of a foreign exchange transaction simultaneously. As a requirement for the rand to be included in the CLS mechanism, the Bank had to move to a system of same day square-off and an amendment to the National Payment System Act, No 78 of 1998 was necessary.

5. Conclusion

In conclusion, may I wish you a successful conference and an abundance of networking opportunities. While commodities as an asset class are in favour at present, it would appear that globally, according to the latest GFMS Gold Survey, the gold sector is poised for an interesting shift in international focus driven by the surge in demand from fabrication; possible pressure on the US dollar; lower world growth boosting the interest in alternative assets; and inflation concerns stemming from the high price of oil. Platinum group metals have been buoyant, in part aided by the rally in the gold price and the continued autocatalyst demand. This is good news for South Africa, the world's biggest precious metals producer. So you have much to discuss.

Work aside, please do take the time to experience some of the more relaxing aspects of South Africa once you are done with the business of precious metals. Finally, let me wish you all a very pleasant stay in South Africa and a safe journey home.

Thank you.