Dr X P Guma: Economic developments in South Africa during 2005 and prospects for 2006

Address by Dr X P Guma, Deputy Govenor of the South African Reserve Bank, at the conference on South Africa: Today and Tomorrow, London, 24 January 2006.

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1. Chairperson, distinguished guests, ladies and gentlemen, it is a great honour for me to address you this morning, not least because the confluence of favourable developments referred to by President Thabo Mbeki in his State of the Nation address early last year has indeed contributed to another banner year for South Africa.

Today, I wish to highlight only a few of the most important domestic economic developments that have transpired during 2005 and some of the encouraging prospects for 2006.

2. Growth in real gross domestic product amounted to 4,5 per cent in 2004, and preliminary anecdotal evidence suggests that this performance may have been exceeded somewhat in 2005. The record economic upswing in South Africa continued apace throughout 2005 and the third quarter marked the twenty-fourth consecutive quarter of uninterrupted growth since the economy began the current upswing in 1999. This is the longest upswing in the recorded economic history of the country.

2.1 The performance of the South African economy in recent times has also been more solid and consistent than before. One of the reasons is that the economy is in the process of changing from one driven predominantly by consumption, to one driven to a greater degree by fixed investment. The growth momentum over the past year-and-a-half was sustained by strong domestic expenditure, alongside the stronger world economy and generally favourable terms of trade.

2.2 Growth in real gross domestic expenditure picked up considerably in the third quarter of 2005 as both fixed capital formation and inventory accumulation gained momentum. Growth in real fixed capital formation accelerated mainly on account of higher capital spending by the private sector.

3. With gross domestic expenditure consistently exceeding gross domestic product over the past three years, the current account of the balance of payments has recorded a deficit during ten consecutive quarters. Buoyed by rising imports of capital and consumer goods as well as crude oil, the volume of imports rose faster than the volume of exports over this period. Favourable export prices and the fairly strong external terms of trade nevertheless contributed to the containment of the current-account deficit. Surpluses on the financial account of the balance of payments moreover more than fully covered the deficits on the current account, leading to continued surpluses on the overall balance of payments over the past seven quarters.

4. Apart from significant inflows of capital in the form of portfolio and other capital, large direct investment inflows contributed to stronger gold and other foreign-reserve levels.

Foreign direct investment into South Africa was bolstered by the acquisition of a majority interest in a South African bank by an international banking group, as well as by increased shareholding by a non-resident investor in a domestic telecommunications company and other significant foreign direct investment announcements which are indicative of an increasingly positive investment outlook for South Africa.

The sustained capital inflows into the country have allowed for the continued build-up of the official foreign reserves and this, in turn, has contributed to the relatively moderate amplitude of the exchange rate movements of the rand. The South African Reserve Bank’s gross reserves now stand at almost US$21 billion – more than US$6 billion higher than a year ago.

5. The responsible economic policies pursued by the authorities and improved prospects for the economy were recognised by three rating agencies that upgraded their rating of South African debt instruments during the course of the past year. The improvement in South Africa’s long-term foreign currency debt rating from BB (high risk, speculative grade credit) in 1994 to BBB+ in 2005 (investment grade rating), made South Africa’s debt much more attractive to the international investing community thereby contributing towards tighter spreads on South African debt. The yield spreads on South African foreign-currency denominated bonds continue to remain substantially lower than those of emerging markets in general (the Emerging Market Bond Index), indicating that investors share the

confidence expressed by international rating agencies and regard South Africa in an increasingly positive light in comparison to competitors.

6. The Eurorand bond market witnessed a flurry of activity this year, with a total net issuance size for 2005 of close to R6 billion, the highest net issuance since 1999. The issuance of randdenominated bonds by non-resident borrowers in the Japanese Uridashi market also continued to grow during 2005 and demand for rand-denominated bonds issued by highly rated non-resident institutions contributed positively to the value of both the rand and domestic bonds.

7. Non-residents have also been very active participants in the domestic bond and equity markets this year. Non-resident participation in trading on the Bond Exchange, measured as the sum of their purchases and sales as a percentage of total purchases and sales of bonds, increased markedly from a level of about 9 per cent in early 2004 to as high as 18,9 per cent by early 2005. Furthermore, non-resident participation in share trading on the JSE averaged approximately 20 per cent in both 2004 and 2005. South Africa also attracted some secondary listings of foreign companies on the JSE Securities Exchange as well as the first listing of a non-resident bank on the Bond Exchange, again displaying increased confidence in South Africa. Prices in the financial and real-estate markets have reached new record highs and financial and real-estate markets have remained buoyant, but the rate of increase in real estate prices, which at times exceeded 35 per cent on a year-on-year basis in 2004, tapered off significantly over the course of 2005.

8. Inflation picked up in the second half of 2005 in response to the increase in the prices of crude oil and its derivative products. However, when crude oil and petrol are excluded from the production price index and consumer price index baskets, the inflation in the prices of the remaining items remained quite subdued, suggesting no firm evidence of second-round inflationary effects arising from the oil price increase. Moreover, the targeted twelve-month CPIX inflation rate – which incorporates petrol price inflation – only accelerated to a high point of 4,8 per cent in August 2005 and subsequently receded to 3,7 per cent in November, partly on account of the somewhat lower levels of international oil prices at the time. So far, the high oil price has therefore not prevented CPIX inflation from remaining comfortably within the target range of 3 to 6 per cent – an outcome which has been maintained for 27 successive months, and which has helped to anchor inflation expectations.

9. The exchange rate of the rand appreciated significantly towards the end of 2005 and in the first part of January 2006. From its most recent dip at the end of October to R6,71 against the US dollar, it appreciated by more than 11 per cent to trade below R6,00 level by mid-January 2006. Although much of this appreciation mirrored the recent depreciation in the value of the US dollar, the rand has also gained significant ground against the other major currencies. As a result, the nominal trade-weighted index of the rand increased by a similar percentage over this two-and-a-half-month period of 99.18 on 17 January – stronger than its year-end peak recorded in December 2004. In the year to 20 January, the TWI has increased by almost three per cent. A notable development in the exchange rate of the rand during the last few months has been that it has become less volatile: the rand's historical volatility – a measure based on an average daily standard deviation calculation – declined from almost 21 per cent in June 2005 to below 10 per cent in October 2005, and has remained there in the subsequent two months.

9.1 It bears repeating the fact that the South African Reserve Bank (the Bank) has been given a target for inflation: it has not been given a target for the exchange rate. Of course, the Bank cannot disregard the exchange rate because the exchange rate can exercise considerable influence on developments in inflation. But the Bank understands that neither it nor anyone else can claim with any confidence to know the equilibrium level or time path of the exchange rate. The Bank also understands that to switch focus to the exchange rate could mean losing control of inflation.

10. Broadening access to financial services, targeted investment and increased economic cooperation remain high priorities on the agenda for South Africa and the Bank continues to monitor and support new initiatives in this regard. The Bank makes a significant contribution to economic co-operation in Africa by liaising closely with the Association of African Central Banks regarding the implementation of the African Monetary Cooperation Programme. 10.1 In February 2005 the Bank hosted a Seminar with the European Central Bank (ECB), attended by Southern African Development Community (SADC) Central Banks in which views on the road towards a Single Central Bank for SADC were discussed against the background of the ECB experience. The MoU on the Harmonisation of Legal and Operational frameworks of SADC Central Banks was finally approved by Ministers for Finance at their meeting held on 5 August 2005 after extensive consultations. At their September 2005 meeting, the Committee of Central Bank Governors (CCBG) in SADC signed Memoranda of Understanding (MoUs)

on Exchange Control, Information and Communications Technology and Payment, Clearing and Settlement Systems.

10.2 Looking forward to the future, it is the case that there are promising signs that the targeted inflation rate will remain within the stipulated range. This, as my former colleague Ian Plenderleith noted, is not just something to look back on with satisfaction. Rather, it is important to recognise that the stable framework for a normal, wellrun economy that has been achieved to date provides the foundation for sustained, if not improved economic performance in the years ahead.

10.3 Going forward, further structural reforms will be important prerequisites to unlocking the economic growth and development potential of South Africa. All of theses reforms will need to be nurtured carefully and it is crucial that they be supported throughout by a stable and transparent macroeconomic policy framework.

10.4 In conclusion it is reasonable to look forward to the future with confidence: and this we do.

References

T. Mbeki (2005) “State of the Nation Address”

I. Plenderleith (2004) “Always Something Normal from South Africa”