T T Mboweni: The economic and financial context for supply chain management

Address by Mr T T Mboweni, Governor of the South African Reserve Bank, at the Professional Society for Supply Chain Management (SAPICS) Conference, Sun City, 5 June 2006.

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1. Introduction

Ladies and Gentlemen, thank you for inviting me to address this conference. I am certain that the efforts of your members in ensuring successful supply chain logistics in many sectors have played a very important supportive role in South Africa's impressive economic achievements in recent years. Your successes are also evidenced by the moon rock you have secured so successfully for this event! No doubt you will continue to contribute meaningfully to making 2006 yet another year of significant positive growth in our economy. Customers worldwide are demanding ever higher levels of service and efficiency. And your society is to be commended for its sterling work in ensuring that South Africa's growth potential is enhanced as companies adopt improved supply chain logistics in order to compete more effectively in a global environment that is characterised by increasing competitiveness and just-in-time processing and delivery. Of course, the economic context within which you operate is crucial to your success, too.

2. Recent domestic economic developments

The South African economy has been in an upswing since September 1999, making the current business cycle expansion phase the longest on record. The upswing continues apace, with strong growth in the South African economy during the first quarter of 2006 as global growth provided a solid tailwind, inflation pressures were relatively calm and interest rates were steady. This is quite a remarkable achievement, given the domestic, regional and international challenges that have confronted South Africa during the course of this upswing.

Real gross domestic product recorded an average annual growth rate of almost 5 per cent for the year 2005, which constitutes the highest annual growth rate since 1984. Although there was a deceleration from 4,1 per cent in the third quarter to 3,2 per cent in the fourth quarter of 2005, growth accelerated once again in the first quarter of 2006 to 4,2 per cent. Despite negative growth being recorded in the primary sector, the acceleration in growth was achieved due to the recovery in manufacturing output and continued buoyancy in other secondary and tertiary sectors. The seasonally adjusted real value added by the agriculture, forestry and fishing industry decreased by an annualised rate of 6,9 per cent during the first quarter of 2006 mainly due to the poor performance in the production of field crops. Following the decrease of 5,4 per cent in the fourth quarter of 2005, real value added by the mining and quarrying industry decreased at an annualised rate of 2,9 per cent during the first quarter of 2006 due mainly to declining gold production. However, growth in the real value added in manufacturing recovered significantly in the first quarter as other sectors such as construction, trade and other services remained extremely buoyant in the first quarter of 2006. The real value added by the non-agricultural industries (excluding the impact of the volatile agriculture industry) for the first quarter of 2006 increased by 4,7 per cent compared with the fourth quarter of 2005.

Importantly for our members, the manufacturing sector is in an expansionary phase. The seasonally adjusted PMI for May, released this past week, showed the manufacturing sector expanded for the third consecutive month from a level of 54,3 in April to 57,6 in May. Some of the components that strengthened include the business activity component, new sales orders and suppliers' performance. However, the PMI indicates that inventories fell from April's level. And indications are that inventory investments in the manufacturing sector slowed in the fourth quarter of last year partly because of low crude oil imports and problems with the change to unleaded petrol. Many of these areas affect the members of your association but I am sure you are generally satisfied with the economy's performance, thus far.

Growth in real gross domestic product in South Africa is expected to remain above the 4-per-cent level for this year as a whole, driven primarily by the robust trend in domestic expenditure. According to the April 2006 Reuters consensus forecasts, the South African economy is expected to grow at 4,5 per cent in 2006 and 2007, and by 5,0 per cent in 2008. In its Budget Review, the National Treasury expects economic growth of 4,9 and 4,7 per cent for 2006 and 2007, respectively. The strong growth momentum in household consumption expenditure and gross fixed capital formation is expected to continue to be the prime driver of growth over the medium term.

Despite the recent increases in the fuel price which may somewhat dampen household spending on other items, growth in consumption expenditure is expected to remain robust as a result of sustained real disposable income growth due to expected continued generation of employment and real salary and wage increases. This, together with the favourable wealth effects of higher asset prices, the lower interest rate environment and the up to now contained inflationary pressures, as well as the government's personal income tax relief package announced in the February 2006 Budget, should continue to sustain the expected growth momentum in real household spending. Government also remains committed to its objective of generating long-term sustainable economic growth through its planned spending on public-sector infrastructure and deeper micro-economic interventions (structural reforms).

Government's continued commitment to improve key infrastructure and social development programmes was highlighted emphatically in the President's state-of-the-nation address to Parliament earlier this year, when he announced that the Accelerated and Shared Growth Initiative of South Africa (ASGISA) would serve as catalyst to efforts to halve unemployment by 2014. Under ASGISA, large investments will be made in various sectors to improve infrastructure. The President announced a massive investment initiative and promised that government would tackle the skills shortages and speed up the process of achieving even higher levels of real economic growth. Government intends investing R372 billion within three years in order to push economic growth to higher levels.

Business confidence levels generally remain upbeat and private-sector investment sentiment remains strong. This has probably been meaningfully supported by the announced increases in parastatal capital expenditure. The surge in business investment is also expected to translate into higher export volumes. A number of new projects in the mining of iron ore and gold have been identified and should commence in the medium term. Vehicle manufacturers are in the process of expanding capacity and cement companies have also been expanding their capacity in order to meet the construction sector's demand for cement. Capital formation in the construction and commerce sectors should continue to benefit from robust domestic demand. In the 2006/07 Budget several projects were announced which should boost real fixed investment by the general government in the medium to long term. These include: Infrastructural development to improve the provision of water and sanitation; construction of schools, clinics and provincial roads; the upgrading of informal settlements; the expansion of economic and transport infrastructure; and capital expenditure in preparation for the 2010 FIFA World Cup. The work that is underway at Transnet is absolutely central to the micro-economic story going forward.

The comprehensive preparations for the World Cup Soccer tournament in South Africa in 2010 should help to stimulate construction activity significantly i.e. via the anticipated investment in soccer stadiums and the expansion and upgrading of accommodation facilities. Eskom, Transnet and Telkom also have exceptionally large capital projects in the pipeline and state-owned enterprises are projected to invest about R123 billion in capital expenditure over the next three years (with R32 billion of this amount being spent on rail and port infrastructure).

As could be expected, the lengthy upswing in economic activity and expenditure has been accompanied by a strong increase in import volumes. Import volumes primarily reflect the strong growth in consumption and investment expenditure and are consequently expected to track the pace of growth in domestic demand closely. Accordingly, the current account of the balance of payments moved into deficit from 2003 and the deficit amounted to approximately 4½ per cent of gross domestic product in 2005. However, 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, significant inflows of financial capital have been recorded over the past three years, exceeding the current-account deficits and enabling the South African Reserve Bank to increase the gold and other foreign exchange reserves. Export volumes are also expected to continue benefiting from the projected global growth, the African Growth and Opportunity Act, and Government's Motor Industry Development Programme.

3. International economic developments

The international economic environment has also supported domestic economic developments. Although there was a slight slowdown in the latter part of 2005, global economic activity managed to maintain a solid pace of growth throughout the year. This lent further support to the rising trend in the international commodity prices which accelerated strongly in the fourth quarter of 2005 and first quarter of 2006. More recently commodity prices have retraced somewhat, but this may prove to be a temporary correction given consensus forecasts for global demand.

Ministers from OECD countries last week expressed optimism about prospects for the world economy, with continued strong growth and moderate inflation, but warned that further rises in energy prices could pose a significant risk. OECD ministers expect the buoyant pace of world growth witnessed in the past few years to be sustained in the near future. Their comments echoed the OECD's twice-yearly *Economic Outlook* released last week, which painted a broadly positive picture of growth prospects while sounding a warning over future energy price rises and current-account imbalances. OECD ministers observed that inflation was likely to remain under control, despite shrinking spare capacity and higher commodity prices, this being so because heightened international competition would help contain prices.

A *Wall Street Journal* report which was also published last week nevertheless sounded a warning and suggested that if the story of today's international economy were handed down as a fable, recent developments might result in it being called "Global Goldilocks Meets the Three Bears." The reasoning behind this is that “Goldilocks -- a.k.a. the world economy -- has been enjoying a not-too-hot, not-too-cold 4-per-cent plus growth rate over the past four years thanks to steady prices”, robust U.S. growth and the new wealth experienced by emerging markets countries. However the Journal goes on to identify the three growling bears that are threatening to spoil the fairy tale.

Mama Bear is the “increasing energy insecurity, a beast spawned by rising oil prices but made more dangerous by escalating political risk afflicting almost all the major producers: Iran, Iraq, Nigeria, Venezuela, Russia and Saudi Arabia. Papa Bear comes in the form of deflating housing prices in several countries. The lost wealth effect of inflated property values, whether gradual or sudden, could unsettle not only” American consumers -- but also hit other countries with similar problems of high debt ratios and low savings. “Baby Bear is inflation, whose sudden growth in some countries” has spooked the global market and sparked the recent sell-off on the expectation that higher interest rates could slow corporate growth and consumer spending. The important question is whether recent significant market corrections were short-term in nature or whether they were the “sort of overdue awakening to risk” that many economists have been predicting. Some are even convinced that markets are finally responding to "unsustainable global imbalances" -- symbolised by record U.S. deficits and Asian surpluses. But as we are all, too aware, markets do over-react from time to time. We hope that calm will soon return for there is a lot of value out there.

Oil prices, property prices and inflation do not only pose dangers to the US economy but certainly pose significant dangers to many other countries including our own. Although economic doomsayers often have been proven wrong in the past few years by the remarkable resilience and flexibility of the U.S. and other leading economies, the threatening nature of these bears is something to keep a close eye on.

Consumers are more likely to reduce their spending the longer energy prices stay high and the more they worry about asset values. Although some may argue that this is not much of a threat given that oil prices have risen to $70 a barrel without slowing global growth or igniting second-round inflation, geopolitical risks unabated and could interrupt oil supplies from a number of important oil producers. Political risks could escalate even as oil supplies remain tight. We can only hope that the collective global political leadership will exercise wisdom in dealing with these geopolitical issues.

This time the real-estate-bubble threat is more global than is often realised. It has become the symptom in many countries across the world that, during this long period of low interest rates, they have developed similar problems in real estate. As market pressures on such nations increase, investors begin to worry more about risk exposure. Currencies are trading down in the U.S. and several other such economies, including our own, followed by withdrawals from equity and bond markets.

The release of U.S. consumer-price data for April triggered global shock waves as it was the strongest indication yet that prices were rising in a more sustained manner, particularly for services, a large part of the U.S. economy in which higher costs are not quickly reversed. The underlying concern therefore

revolves around the sustainability of the U.S.'s five-year expansion if the three bears bring a triple setback for U.S. consumers. Global Goldilocks' safe escape depends on the wisdom and political determination to simultaneously ensure that a benign energy demand/supply equilibrium is restored, that global imbalances unwind in an orderly fashion and that inflation is successfully contained. Global leaders' ability to tame these bears will be severely tested in the months ahead. In the meantime, the South African Reserve Bank will continue to monitor important indicators to ensure that the monetary policy stance remains appropriate.

5. The outlook for inflation

The primary role of the South African Reserve Bank in the domestic economy is to target inflation for the benefit of all economic players. CPIX inflation has remained within the target range for the past 32 months and the Monetary Policy Committee has been greatly encouraged by the evolution of some of the components of CPIX. It has become clear that there has been a steady convergence of the inflation rates of many of the categories of goods and services which make up the index to within the target range of 3-6 per cent. In the meantime, domestic monetary policy has continued to emphasise price stability and has succeeded admirably in reducing inflation expectations. According to the Bureau for Economic Research inflation expectations survey, inflation expectations for 2006, 2007 and 2008 of all the categories of respondents (business executives, trade union officials and financial analysts) are below 5 per cent which is nicely within the inflation target range.

However there are a number of unfavourable trends and risk factors. These include rising crude oil prices and their impact on global growth and inflation, including the possibility that secondary inflationary pressures may be stimulated; the recent acceleration in domestic producer price inflation; the recent movements in the rand exchange rate; and the possibility of rising domestic capacity constraints.

Favourable factors contributing to downside inflation risks include increased competition from Asia that can potentially lower price pressure on a range of internationally traded goods; moderate unit labour costs; encouraging administrative prices trends; and a continued benign global inflationary environment.

6. Conclusion

In conclusion, the macroeconomic environment remains extremely favourable for sustained growth. The South African Reserve Bank will continue to play its part in strengthening South Africa's economic growth potential. This we will do by striving for the appropriate policy setting in containing inflation. This, we are convinced, will provide the supporting factor for enhanced growth, development and employment creation. The significant long-term decline in the inventory to GDP ratio that we have witnessed over the years is testimony to SAPICS' important role. I wish you every success with this year's conference and trust that your deliberations and networking during the next few days will lead to your members embracing the latest technologies and supply chain methods to contribute towards higher levels of productivity outcomes in the years ahead. Conferences of this nature are extremely important vehicles for enhancing knowledge transfer and ensuring a greater infusion of expertise in the economy. This is very important for boosting economic performance, competitiveness and employment creation. Let us all do our bit.

Thank you.