T T Mboweni: The outlook for the South African Economy in a period of uncertainty

Address by Mr T T Mboweni, Governor of the South African Reserve Bank, at the London Capital Club, London, 27 June 2006.

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Ladies and Gentlemen,

1. Introduction

I was very pleased to have received this invitation to address the members of the London Capital Club today for two reasons. Firstly, I suspect that this club might contain within its history the first seeds of central banking. I believe this Club builds on the proud foundations of the Gresham Club, named after Sir Thomas Gresham. And I was interested to learn that Sir Thomas was an advisor to King Edward VI in 1551 on the financial difficulties facing the country at the time. Sir Thomas implemented a set of plans to overcome these difficulties, which raised the external value of the pound. In his management of these problems, one can perhaps conclude that Sir Thomas was one of the first-ever central bankers. Indeed, Sir Thomas might have had an easier task if England had already followed a policy of inflation targeting at the time as both South Africa and England do today.

The second reason why I am delighted to be here today is that the South African Reserve Bank has a direct association with the London Capital Club. One of our former Deputy Governors, Ian Plenderleith, CBE, serves on the Board of Advisors of the Club. I am therefore indeed honoured today to make a contribution to your deliberations but, more importantly, to enjoy lunch with you.

Recent upheavals in the international markets have placed the spotlight again on emerging markets. There is disagreement in the markets as to what this burst of global volatility actually reflects, with answers ranging from inflation concerns, to global liquidity and to the growth outlook. South Africa has in the past few weeks experienced significant movements in the rand exchange rate and stock market prices. These developments may be seen by some as a threat to South Africa's recent strong growth performance, as well as to the growth strategy of the government. But that should not necessarily be the case.

2. Recent international developments

Emerging markets have enjoyed an extended period of investor exuberance and search for higher yield over recent years, which, combined with a generally supportive environment of strong global growth and high commodity prices, have caused their currencies to appreciate, equity prices to increase and bond spreads to narrow. Recently, we have experienced the effects of greater uncertainty about future inflation, interest rates and growth in the major economies. These concerns, combined with a state of general nervousness about the fairly sharp increases recently in the prices of riskier assets such as equities and commodities, caused many investors to pause, take profits, square positions and generally adopt a lower-risk investment strategy.

The increased risk aversion of global investors was reflected in a number of indicators: The volatility index of the Chicago Board of Exchange (or the VIX), which gives a general reflection of risk aversion in equity markets, doubled from just below 12 on 10 May to almost 24 on 13 June. Prices of foreign-currency denominated bonds of emerging markets also fell, contributing to an increase in the spread of these bond yields over US Treasuries. The JPMorgan EMBI Plus spread widened from 176 on 10 May to 232 on 13 June. The widening in spreads occurred across all the sub-indices of the EMBI plus, with Latin America the most affected. South Africa's spread widened relatively less, from around 80 in mid-May to around 90 in mid June.

The initial sell-off of higher-risk assets commenced in the US equity markets on 11 May following increased market uncertainty regarding the outlook for global interest rates. A marked decline in the S&P 500 index was followed by similar trends in the equity markets of Europe, Japan and the UK. By mid-June, all the year-to-date gains in most of the major equity markets had been wiped out. Equity prices in some emerging markets were even more affected. The South African equity market, which is dominated by the resources sector, declined by over 16 per cent from its peak reached in mid-May.

A number of emerging-market currencies depreciated markedly. Since 11 May until mid-June, the Turkish lira depreciated by over 16 per cent and the Brazilian real by almost 11 per cent. The rand has not fared any better, having depreciated by almost 13 per cent over the same period. As is normally the case whenever investors cut their emerging-market exposures, the liquid South African market has been more severely affected than most of its peers.

The rand exchange rate is strongly influenced by commodity prices, which in turn are dependent on global growth and also by the deteriorated sentiment towards emerging markets. Commodity markets also felt the effects of the sell-off of riskier assets. The price of gold declined from around US$725 per fine ounce in mid-May to around US$570 a month later. Similarly, platinum declined from a high of US$1331 per ounce in May to a low of US$1125 in June. It should be noted however that these changes are exaggerated by particularly strong upward price movements in the previous month. For example, the gold price averaged around US$550 per fine ounce in each of the first three months of this year, whilst the platinum price averaged around US$1040 per ounce in these months. This suggests that there had been some overshooting and that the current trends may be an inevitable correction, rather than a generalised collapse in commodity prices. However, the degree of volatility in commodity markets creates an uneasy environment for commodity-based currencies.

Interestingly, despite the “sell-off” in emerging market assets since May, non-residents have remained net buyers of South African financial assets and there have been significant investment flows into South Africa over the past year. Non-resident investors bought a net R13 billion worth of South African equities during May 2006, and R460 million in the first half of June 2006. Despite generally negative sentiment towards emerging-market assets, they continued to buy R768 million worth of bonds in May, and R4,5 billion in June. These purchases brought the net amount of South African bonds and equities bought in the year to mid-June to R68 billion, compared with R41 billion in the whole of last year. Similarly, Britain’s Vodafone Group paid R21 billion earlier this year to take over VenFin’s stake in the local cellular operator, Vodacom. And towards the middle of last year, British bank Barclays bought a majority stake in local bank, Absa, for an amount of about R33 billion, making this most likely the single largest foreign investment in South Africa to date.

While the market outlook has become more uncertain against the backdrop of a withdrawal of liquidity as well as geopolitical developments which have impacted on the international oil markets, the macroeconomic landscape still appears to be generally favourable, although not without risks. Inflation pressures seem to be building up across emerging markets whilst trade and industrial production trends look robust. High levels of international reserves and current account surpluses in a number of emerging market countries, together with reductions in external debt, have radically improved solvency ratios so that existing volatility, although very large, is unlikely to precipitate any systemic credit events in emerging markets. This is in contrast to the Asian crisis in 1997/98, which was generated by imbalances originating in emerging markets. These recent trends have also left their mark on the South African financial markets. However, not much has changed fundamentally in the domestic economy, and there still seems to be significant appetite for South African financial assets, albeit with a somewhat higher risk premium being priced in. Although South Africa is not a current account surplus country, our low level of foreign indebtedness, both public and private, and improved international reserves position, in conjunction with upgrades from credit rating agencies in the past two years, means that we are likely to be less vulnerable to balance sheet effects that have characterised previous emerging market crises.

3. The growth outlook

From a broader perspective, the above suggests that although a period of heightened volatility and uncertainty may ensue, there should be no undue negative impact on South Africa’s growth prospects. In 2005 and 2005 the South African economy grew at a robust pace of 4,5 per cent and 4,9 per cent respectively. Growth in 2006 is expected to be moderately lower than that achieved last year following the 4,2 per cent measured in the first quarter of this year. This is in sharp contrast to the 3 per cent average annual growth experienced between 1994 and 2003.

The recent strong growth performance has been underpinned by strong consumer demand which grew at annual rates of 6,5 per cent in 2004 and 6,9 per cent in 2005. Sustaining growth at higher levels will require significant structural reforms and an increase in investment relative to consumption as a contributor to the growth process. Gross fixed capital formation has been growing at annual rates of over 8 per cent for the past three years, driven mainly by private sector investment. In recent years, however, parastatal and public sector investment growth has been extremely low, which accounts for the relatively modest ratio of gross fixed capital formation to GDP of 16,8 per cent in 2005. This ratio has however been on a rising trend since 2002.

As you may be aware, the South African government has embarked on the Accelerated and Shared Growth Initiative of South Africa (ASGISA), with the intention of raising the GDP growth rate to around 4,5 per cent until 2009 and 6 per cent thereafter. Central to this strategy is a strong focus on infrastructural investment. As indicated in the Medium Term Budget Policy Statement in late 2005, government and public enterprise investment expenditure for the period April 2006 to March 2009 is planned to be about R370bn. This investment should not only raise current growth, but will also allow for sustained future growth through improved transport, communication and electricity provision.

Estimating potential output of a country is a notoriously difficult thing. The problems of estimation are compounded when a country has been experiencing significant structural changes, as has been the case in South Africa. There is no doubt that over the past few years such changes have raised the efficiency and the potential output of the economy. Previous estimates by the IMF and others had put the potential rate of output growth at around 3 per cent per annum or lower. Preliminary research at the Bank estimates current potential output growth to be in the region of between 4 and 4,5 per cent, assuming no significant changes in the underlying economy. Other scenarios in this study show that if the investment initiatives contained in the government's strategy come to fruition, a potential output growth rate of over 6 per cent can indeed be achieved and sustained.

An important component of the future growth scenario is the availability of finance. South Africa has been running current account deficits in the recent past, and will therefore continue to be reliant on non-resident inflows to finance the investment-savings gap. In the past few years, these deficits have been more than financed by capital inflows which, in turn, are being attracted by the improved growth prospects in the economy. These inflows enabled the Bank to further increase its holdings of foreign exchange reserves. By the end of May, official gross gold and other foreign exchange reserves had increased to US$24,1 billion, while the international liquidity position had increased to US$20,4 billion. This is a significant improvement on the negative average international liquidity position of almost US$10 billion in 2000.

The stronger reserves position is expected to contribute to greater stability in the foreign exchange market and reduce South Africa's vulnerability to external shocks. The recent inflows have been mainly equity or FDI inflows, reflecting the fact that favourable growth prospects have been key, and will be critical for future inflows. The sustainability of these flows will depend in part on the evolution of the current bout of volatility in international markets and investor perceptions towards emerging markets in general, and South Africa in particular. An important element in the growth outlook is macroeconomic stability, which is where monetary policy makes its contribution.

4. The role of monetary policy

The mandate of the Bank is to achieve low inflation in the interest of sustainable economic growth and development. A low inflation environment contributes to growth and development by providing a more certain basis for investment decisions in the economy, and lowering overall risk.

The inflation-targeting framework adopted in February 2000 has contributed to the reduction of inflation to low levels. For the past 32 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, and significantly higher international oil prices. Furthermore, there is evidence that inflation expectations have become entrenched at levels consistent with the target. These developments have allowed for nominal interest rates to fall to levels last seen in the late 1970s. Between June 2003 and April 2005, the repo rate was reduced by a total of 650 basis points, although at the most recent Monetary Policy Committee meeting earlier this month, the repo rate was raised by 50 basis points to 7,5 per cent per annum. Real interest rates have also come down somewhat and have become less variable.

The recent repo rate increase, the first since September 2002, was motivated by the deteriorating risks to the inflation outlook. Apart from adverse oil price developments, the concerns of the Committee also centred around the continuing high levels of consumer demand, which have been reflected in rising levels of credit extension to the private sector and also the larger-than-usual current account deficit on/of the balance of payments. Twelve-month growth in bank loans and advances extended to the private sector measured 23,1 per cent in April compared to 24,3 per cent in March, while asset-backed credit extended to the private sector continued to grow strongly at a year-on-year rate of 27,2 per cent in April. Although there were few signs of inflationary consequences at that stage, the impact was being felt in the deficit on the current account of the balance of payments which had expanded to 6,4 per cent of GDP by the first quarter of this year.

As we observed in our latest Monetary Policy Review, current account deficits are a reflection of higher domestic expenditure and are not in themselves inflationary. There is however a possible risk to the exchange rate if the deficits are perceived to be unsustainable, particularly if the deficits reflect higher consumption expenditure. This is particularly the case where the international markets are re-rating emerging market risk. Under these circumstances, there is the risk of a significant exchange rate adjustment which could threaten the longer-term attainment of the inflation target. The recent events in international markets, particularly with respect to New Zealand and Iceland, show how sensitive market perceptions can be to large current account deficits. Moderately higher interest rates therefore should not be seen to be undermining growth. Failure to respond to inflation risks could, however, be inimical to growth.

5. Conclusion

Despite the recent turbulence in international markets, we are of the view that growth prospects remain sound both in South Africa and in the rest of the world. The inflation threats are likely to subside given the resolute determination of central banks around the world to tighten policy. Although the global interest rate environment may need further tightening and the results of which might be a moderation in global growth, it is unlikely to lead to a significant downturn in global growth. Combined with continued strong growth in China and other Asian countries, this should underpin commodity prices. Nevertheless serious risks remain, particularly those posed by geopolitical events which could have an impact on international oil prices. Domestically, the Bank will continue to play its part by contributing to the favourable growth environment. This we do through ensuring that inflation remains within the target band of 3-6 per cent.

Thank you.