T T Mboweni: South Africa’s economic policy challenges

Address by Mr T T Mboweni, Governor of the South African Reserve Bank, at the XVI meeting of the Central Bank Governors’ Club[1], Irkutsk, Russia, 2 September 2006.

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Governors,
Honoured guests
Ladies and gentlemen

1. Introduction

I am grateful to the Central Bank of the Russian Federation for inviting me to address the Governors’ Club today. I have been informed that one of the main objectives of the Governors’ Club is to promote co-operation in the sphere of central banking among member countries. In the light of the rapid developments in the global financial system, there is little doubt about the benefits of associations such as the Governors’ Club. I trust that the experience of South Africa and the southern African region that I am going to highlight today will be informative to the objectives and activities of the Governors’ Club.

2. South Africa’s economic growth performance

Similar to the many countries participating at this meeting, the South African economy can be described as an economy in transition. It is the largest economy in Africa with gross domestic product in 2005 measuring US$239,4 billion (R1523 billion), compared to US$135,8 billion (R482,1 billion) in 1994. GDP per capita increased from approximately US3,500 in 1994 to approximately US$5000 in 2005, in a country with a population of approximately 47 million people and an annual population growth rate of marginally below 1 per cent. Because of the legacy of the apartheid, there is still a highly skewed distribution of income and wealth in the country. According to recent estimates, the Gini coefficient is approximately 0.65. One of the primary objectives of the current government is to rectify these inequalities. This is a particular challenge given the high levels of unemployment in the country. The most recent unemployment rate for 2005 was approximately 27 per cent, slightly higher than a year earlier.

Although South Africa is a major commodity producer, and commodities or commodity-based products make up a significant proportion of our exports, the contribution of mining to GDP is relatively small at 6 per cent. The largest sector in the economy is the finance, real estate and business services sector which accounts for almost 20 per cent of GDP, followed by the manufacturing sector which accounts for just over 16 per cent. The agricultural sector is one of the smallest sector, contributing about 2,4 per cent of GDP.

Only twelve years ago the country emerged from apartheid, international isolation and economic and financial sanctions. The new dispensation inherited an economy characterised by low growth and high levels of inflation. Growth averaged 1,0 per cent over the period 1984 to 1993, while inflation averaged 14,3 per cent during the same period.

Since then, macroeconomic performance has improved significantly as a result of improved policies. In sharp contrast to the 1,0 per cent GDP growth attained during the decade preceding 1994, South Africa has since experienced twelve years of uninterrupted GDP growth, averaging 3,3 per cent per annum. The economy grew by 4,5 per cent and 4,9 per cent during the last two years and growth this year is also expected to exceed 4 per cent.

[1] The Governors` Club is an association of central banks from Central Asia, Black Sea Region and Balkan Countries. It consists of 19 members from the following countries: Azerbaijan, Albania, Armenia, Bulgaria, Bosnia and Herzegovina, Greece, Georgia, Israel, Kazakhstan, Kyrgyz Republic, Macedonia, Montenegro, Moldova, Russia, Romania, Serbia, Tajikistan, Turkey and Ukraine.

Prudent fiscal management has seen South Africa's budget deficit reduced from 5,2 per cent of GDP in 1994 to 2,0 per cent of GDP in 2004, and 0,3 per cent of GDP in 2005. Monetary policy also underwent a significant 'regime change' during the period, with the adoption of an inflation-targeting framework in February 2000. One of the fundamental objectives behind the adoption of the inflation targeting framework was to enhance policy transparency and accountability and thereby decrease and anchor inflationary expectations over time.

The improvement in the performance of the South African economy needs to be maintained if meaningful progress is to be made in meeting the economic and social challenges facing the country, particularly the eradication of poverty and unemployment. The South African government has, therefore, set itself the goals of halving poverty and unemployment by 2014. To meet these challenges, the government seeks an annual GDP growth rate that averages 4,5 per cent or higher between 2005 and 2009, and an average growth rate of at least 6 per cent between 2010 and 2014. Public infrastructure investment to the value of R370 billion is also planned for the next three years. The targeted interventions in public transport, communication and electricity provision should not only contribute to the growth performance over the next couple of years but also go some way towards increasing the growth potential of the economy.

3. Monetary policy

It is our firmly held view that the best contribution that monetary policy can make towards the attainment of sustainable higher growth rates is to ensure price stability. The mandate of the South African Reserve Bank is defined in the Constitution of the Republic of South Africa as the protection of the value of the currency in the interest of balanced and sustainable economic growth in the Republic. Deriving from this constitutional mandate, the Bank regards its primary goal in the South African economic system as "the achievement and maintenance of price stability". This is currently interpreted as CPIX inflation – that is headline inflation less mortgage interest costs – being between 3 to 6 per cent.

Despite some initial setbacks in late 2001 and during 2002, when inflation increased rapidly in reaction to the significant depreciation of the currency, the inflation targeting framework has served us well. Having averaged 7,9 per cent between 2000 to 2002, inflation has been contained within the target range since September 2003. For the past two years inflation has averaged 4,0 per cent. Without getting into the merits and demerits of inflation targeting, the inflation targeting framework has served as a good anchor for monetary policy in South Africa. It has led to better co-ordination of monetary policy and other economic policies than was the case in the past. The political commitment, as evident in the pursuance of prudent fiscal policies, has been crucial to the containment of inflation within the target band.

In addition, the inflation target provides the basis for the accountability of the central bank and it improves public understanding of monetary policy decisions. The inflation targeting framework has also helped to anchor inflation expectations within the target range, thereby further enhancing confidence in monetary policy. This has, however, not been achieved easily. Although it proved to be unpopular in some quarters, a stringent monetary policy stance had to be adopted initially in order to demonstrate the commitment of the Bank to meeting its statutory obligations and ensuring the credibility of monetary policy. The initially painful experience had a positive outcome, given the subsequent favourable impact on price and wage setting behaviour in the economy.

4. South Africa's financial markets

South Africa is a small open economy by international standards. This in itself presents some challenges for the pursuit of price stability, not least of which is the nature of the South African financial markets. South African financial markets are relatively deeper, broader and more sophisticated than those in a number of emerging markets. According to the latest World Competitiveness Yearbook, South Africa is ranked 46th overall but 22nd in Banking and Financial Services, higher than countries such as Ireland, Spain, France and even the United Kingdom.

Trading in bonds and equities is fully automated and exchange-driven through the Bond Exchange of South Africa (Besa) and the Johannesburg Securities Exchange Limited (JSE), respectively. Corporates currently account for about 32 per cent of the total debt listed on Besa. The turnover on Besa has increased from R2,1 trillion in 1995 to R8,1 trillion in 2005. As at the end of 2005, 388 companies were listed on the JSE. The JSE has evolved into a truly international bourse, with more than 60 companies listed on at least one other exchange internationally, and non-residents accounting for about 20 per cent of the daily turnover. Turnover on the JSE has also grown sharply over recent years, increasing from an annual turnover of R22 billion in 1992 to R1,279 trillion in 2005. The All-share index of the JSE reached record highs in April 2006, gaining around 18 per cent in the year to the end of April. The All-share index is currently trading at levels close to those in April, having recouped some of the losses incurred in May 2006 as a result of developments in international financial markets.

The foreign exchange market in South Africa is the biggest domestic financial market, with an average daily net turnover of US$14,5 billion in July of this year. This consisted of US$1,9 billion spot transactions against the rand, US$1,0 billion forward contracts against the rand, US$7,5 billion swaps against the rand and the balance of US$4 billion consisting of transactions in third (non-rand) currencies. The foreign exchange market is very liquid which makes it an easy target for portfolio re-alignment by international investors. Thus, the potential for a direct impact on the exchange rate of the rand emanating from this source is great. As a result, the exchange rate of the rand is generally more volatile than those of most other emerging-market currencies.

Since 2005, the rand has traded in a fairly stable range. However, as you are aware, the rand is seen as both a commodity and emerging-market currency. As a result, the volatility of the currency has recently increased due to developments in commodity prices and changes in investors' risk appetite for emerging-market currencies. The rise in precious metals prices has provided support to the rand while the currency experienced some weakness – particularly in May – due to the repricing of emerging-market risk. The currency depreciated to levels around R6,60 to the dollar in mid-May from levels of around R6,00 to the dollar at the beginning of the year. The weakening of the currency was essentially due to the sell-off in emerging–market assets in May 2006. The rand depreciated further in June in response to concerns about adverse developments in the current account of the balance of payments. Unlike many of the other commodity producing countries, South Africa has a deficit on its current account, which increases the country's vulnerability to currency movements. I will return to this issue a little later on.

Historically the South African Reserve Bank practiced a policy of intervening in the foreign exchange markets in an attempt to smooth the volatility of the exchange rate. With no success, I must mention! These activities resulted in huge losses amounting to almost US$24 billion emanating from the oversold net open forward position of the SARB. The unsuccessful and costly policy of intervening in the foreign exchange market has convinced us that it is better to leave the determination of the exchange level of the rand to the market. The SARB has stuck to this policy even when the rand depreciated to R13,89 to the US dollar in late 2001 from levels around R8,00 to the US dollar at the beginning of 2001. Some analysts believe that this was a test of SARB's resolve not to intervene in the foreign exchange market.

Currently, the Bank's activities in the domestic foreign exchange market are aimed at building foreign exchange reserves, smoothing money-market liquidity conditions through intra-month foreign exchange swaps and meeting clients' foreign currency needs. The strategy of accumulating reserves is done in such a way that we "cream off" excess "dollars" in the market without any significant influence on the exchange rate. The accumulated gross gold and other foreign exchange reserves now amount to over US$24 billion and, combined with prudent macro-economic policies, has led to South Africa's credit rating moving up four notches over the last twelve years - from BB in 1994 to BBB+ in August 2005. As you know, maintaining reserves is an expensive exercise – the challenge is therefore to ascertain and maintain a level of reserves that supports the economic fundamentals of the country. However, the increase in reserves, together with the eradication of the Net Open Foreign Currency Position, should contribute towards the stability of the currency and reduce uncertainty for both domestic and non-resident investors.

5. Monetary policy challenges

Let me now turn to some of the monetary policy challenges currently facing South Africa.

The favourable inflation trend over the last couple of years has allowed for nominal interest rates to fall to levels last seen some three decades ago. Between June 2003 and April 2005, the repo rate was lowered to 7 per cent, representing a total reduction of 650 basis points over the period. After remaining unchanged for 13 months, the repo rate was increased by 50 basis points at each of the

MPC meetings in June and August this year. Given the increase in inflationary pressures and the resultant deterioration in the risks to the inflation outlook, the Monetary Policy Committee considered it necessary to tighten policy at the last two meetings.

The main factors that have recently led to the heightening of the risks, namely the high levels of consumer spending, adverse movements in the exchange rate, a larger current account deficit, higher food prices and high oil prices.

Consumer spending has been increasing at robust levels for some time now. The low interest rate environment has fuelled rising levels of credit extension to the private sector. Growth in bank loans and advances extended to the private sector measured at annual rates have recently increased to levels exceeding 20 per cent. While the inflationary effects are limited at this stage, the impact is manifesting itself via the deficit on the current account of the balance of payments, which had increased to 6,4 per cent of GDP by the first quarter of this year.

While the deficit is currently more than adequately financed by capital inflows, these are mainly portfolio inflows, which increase the risks of adverse movements in the exchange rate, especially if the current account deficit is perceived to be unsustainable. This situation makes the exchange rate particularly vulnerable to changes in investor sentiment and risk tolerance, which can result in a tapering off or even withdrawal of portfolio inflows. This issue is of particular relevance given the way in which international markets have been re-rating emerging market risk recently. In such circumstances, there is an increased risk of a significant exchange rate adjustment which could threaten the longer-term attainment of the inflation target. However, the best way to avoid this happening is by maintaining sound and prudent macroeconomic policies.

While we do not target any specific level of the exchange rate, exchange rate developments impact significantly on inflation. For a small and open economy like South Africa, the pass-through effects of exchange rate changes on inflation are significant and rapid. Hence, monetary policy has to take due cognisance of the fluctuations in the exchange rate of the rand insofar as their effect on the inflation forecast is concerned.

On the issue of oil prices, these have been at sustained high levels for some time now. Given the prevailing geopolitical tensions, there is little doubt that oil prices pose the single biggest threat to global growth and inflation. However, the challenges for monetary policy emanating from high oil prices are not so straightforward. The textbook recommendation is that monetary policy should not react to first-round oil price effects but rather prevent second-round effects from taking hold. The pass-through effects from oil price increases to the different indicators of inflation have been relatively low, with the result that pre-emptive monetary policy decision-making has not been easy. However, there are indications that secondary inflationary pressures from the oil price increases are starting to occur in South Africa, as is evident in the recent acceleration in domestic producer price inflation.

The recent tightening of monetary policy should thus be viewed in the context of the deterioration in the risks to the inflation outlook and the objective of the SARB to ensure the credibility of monetary policy and sustainable economic growth in South Africa.

5. Regional co-operation among central banks in Africa

Let me now move to the issue of regional co-operation among central banks in the southern African region.

Initiatives such as the Governors’ Club, which promote regional co-operation, are vital for success in our modern world, one that is becoming increasingly globalised. Globalisation has brought many benefits, not least of which have been the disinflationary trends that many of our countries have experienced. However, the painful experience emanating from the adverse developments in international financial markets is also fresh in our memories and hence, one cannot over-emphasise the importance of co-operation, particularly among central banks. I am glad to report that central banks in Africa have been actively co-operating on different initiatives for some time now.

As you may be aware, African political leaders have adopted the New Partnership for Africa’s Development (NEPAD). This is a multidimensional development framework encompassing economic, political, security, social and cultural dimensions of development. The African Monetary Co-operation Programme (AMCP) which underpins monetary co-operation between central banks, forms an important part of the economic objectives of NEPAD. In the main, this involves a single monetary union, encompassing a common currency and a common central bank by the year 2021.

At the continental level, the Association of African Central Banks subscribes to the AMCP while the Committee of Central Bank Governors in SADC (CCBG) spearheads the various continental initiatives in the southern African region. The South African Reserve Bank (SARB) plays an active role in both these fora.

The CCBG was established in 1995 with the specific purpose of achieving closer financial/ monetary co-operation and integration in the SADC area. There are a variety of initiatives that the central banks have been, or are currently involved in, which promote monetary integration within SADC. These have *inter alia* spanned the areas of national payment systems, bank supervision, human resource development and legal issues.

In some instances the co-operation has been formalised through the signing of Memoranda of Understanding (MOU). There is little doubt that all the central banks in the region have benefited from co-operating with one another. We have found that co-operation is not only advisable, but a necessity for efficiency in central bank operations in southern Africa.

6. Conclusion

In conclusion, I would once again like to reiterate my sincere appreciation for this invitation to address you today. I wish the Governors' Club every success in its endeavours and would like to assure you of our co-operation and support. I believe that sharing experiences can provide invaluable lessons going forward.

Thank you very much.