T T Mboweni: An overview of the economic challenges of 2006

Address by Mr T T Mboweni, Governor of the South African Reserve Bank, at the Annual Dinner in honour of the Ambassadors and High Commissioners accredited to the Republic of South Africa, Pretoria, 30 November 2006.

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Your Excellency, the Dean of the Diplomatic Corps
Your Excellencies, Ambassadors and High Commissioners
Your Excellency, the Chief of State Protocol
Your Excellencies, Heads of International Organisations represented in the Republic of South Africa
Deputy Governors of the South African Reserve Bank
Senior officers of the South African National Defence Force
Senior Management of the South African Reserve Bank and their spouses/partners
Editors and other media representatives
Ladies and Gentlemen

1. Introduction

It is an honour to welcome you once again to the South African Reserve Bank for what has become an annual event on our calendar. Every year I am humbled by the turnout, and this year is no exception.

This past year has been an extremely challenging one from a monetary policy perspective. Some of the challenges have emanated domestically, but external economic and geopolitical events have also provided challenges to us as well as to many other central banks around the world. This evening I will give a brief broad-brush review of some of these developments. Further details can be found in our publications, including our Quarterly Bulletin which will be released next week. I am aware that one of the issues that is close to your hearts in the diplomatic community is the behaviour of the exchange rate of the rand as your purchasing power in this country varies inversely with the fortunes of the rand. I have noticed that many of you are looking a lot happier tonight than you were this time last year!

2. The external environment

The recent World Economic Outlook published by the International Monetary Fund (IMF) characterised the global economic environment as robust, with economic activity exceeding expectations. While the global expansion has in general been broad based, the improved growth performance of developing and emerging economies compared to that of developed economies has been most noteworthy. This improvement has taken place across all regions, including sub-Saharan Africa. As a group, developing countries now account for more than half of total world gross domestic product (GDP) in purchasing-power parity terms.

This past year has been overshadowed by a high degree of volatility in the international oil markets, which posed a risk to the outlook for world growth and inflation. During the course of the year, the price of Brent crude oil reached new highs of almost US$80 per barrel as a result of tight supply and demand conditions as well as geopolitical developments. Since then the markets have stabilised somewhat and prices are currently around US$60 per barrel.

The pressures on world inflation have also been reinforced by high levels of capacity utilisation and strong global consumer demand. Consequently, we have seen the adoption of a general monetary policy tightening cycle in many countries. During the past year, most industrialised and emerging market central banks have raised interest rates at some point. These actions are expected to keep world inflation under control.

The global imbalances which have persisted over the past few years have been topical issues in the IMF, World Bank and G20 forums. The anomaly of the current global imbalances is that developing countries, particularly those in Asia are now the financiers of the current account deficits of the United Sates and other industrialised countries. A major concern is whether or not the elimination of these imbalances will take place in an orderly fashion. Although the dominant view is that the process will be orderly, the risk remains that the international economy could be in for turbulent times should a disorderly process emerge. It is probably too early to assess whether the current volatility we are observing in the international currency markets is the beginning of this adjustment process, or to predict how this process will unfold.

Until May this year, emerging markets had enjoyed an extended period of investor exuberance and search for higher yield, which, combined with a generally supportive environment of strong global growth and high commodity prices, caused emerging market currencies to appreciate, equity prices to increase and bond spreads to narrow. However, in May, uncertainty regarding future inflation, interest rates and growth in the major economies contributed to some repricing of these assets. Following the anxieties caused to the markets by the widening current account deficits of Iceland and New Zealand earlier in the year, those countries which were perceived to have greater external vulnerability as a result of either high current account deficits or higher levels of external debt, were most affected. South Africa was among these, and as a result the rand depreciated significantly during the second and third quarters of 2006.

Fortunately this episode was relatively short-lived and the latest indicators suggest that emerging markets have generally recovered and are enjoying renewed appetite among global investors for higher yielding assets. On the positive side, it seems as if emerging markets have become more resilient to sudden changes in investor sentiment than they were at the time of the Asian crisis in 1997/98.

A major disappointment during 2006 was the inability of trade negotiators around the globe to conclude or, at least, continue with discussions in the Doha Round of the World Trade Organisation. There is no doubt that the major reason for the Doha breakdown is to be found in disagreements over agricultural sector protection. The failure of these trade negotiations came as a major disappointment to developing countries in all regions, but the ultimate cost could be borne by both developed and developing nations. Apart from the foregone opportunities for both developed and developing countries that a successful conclusion would have provided, of greater importance are the losses that all will be incurred if the world trading system is allowed to deteriorate with a reversion to protectionism.

3. Domestic economic developments

On the domestic front, 2006 has proved to be an eventful and challenging year, which has been influenced to a significant degree by the international developments that I have made mention to above. From a monetary policy perspective, we have continued to achieve our mandate, which is to keep CPIX inflation within the target range of 3-6 per cent. Inflation has been within this range since September 2003 which enabled us to reduce nominal interest rates by a total of 650 basis points between June 2003 and April 2005. In recent months the trend of inflation has been rising, and in October CPIX inflation measured (5%) per cent compared to 3,7 per cent in April of this year. Furthermore our forecasts suggest that inflation could reach the 6 per cent level by the second quarter of next year. In response to the deteriorating inflation outlook, the monetary policy stance was adjusted in June of this year when we increased the repo rate by 50 basis points. The repo rate was increased further by 50 basis at each of the subsequent meetings in August and October.

For much of the year, international oil price developments posed a major risk to inflation. The price of 95 octane petrol increased from R5,49 per litre in January 2006 to peak at R7,04 per litre in August. Fortunately pressures on inflation from this source dissipated somewhat with the decline in the international oil prices and since August domestic petrol prices have declined by a total of R1,07 per litre. Despite this recent moderation, we still see the international oil price being vulnerable to global geo-political tensions, and therefore it continues to pose an upside risk to our inflation outlook.

Of concern to us during the year was the persistent rise in domestic consumer demand which in recent times has been increasing at a year-on-year rate of around 8 per cent. This consumer exuberance has been financed by high rates of domestic credit extension and has led to record levels of consumer indebtedness of around 70 per cent of household disposable income. Contributing to these high levels of demand have been rising real incomes, increased employment, lower interest rates and higher asset prices. Both the housing market and equity markets have remained buoyant. The equity market in recent weeks has reached new record highs, having recovered from the reversal it suffered during the international market volatility in May and June when the all-share index declined by as much as 16 per cent.

The rand exchange rate was also not spared the fall-out of the emerging market jitters in May and these developments have had an impact on the inflation outlook. Having traded in a relatively narrow trading range for much of the first half of this year, the exchange rate reacted to the global risk aversion, and between 11 May and the middle of June it depreciated from R6,10 to the US dollar to around R6.80. Subsequently, concerns relating to the widening current account deficit on the balance of payments in excess of 6 per cent of GDP caused the exchange rate to depreciate further. At one stage the exchange rate had depreciated to around R7,90 to the US dollar in early October, but more recently it has been trading at levels of around R7,20.

In part the depreciation of the rand during 2006 should be seen as an element of the adjustment to the then widening current account deficit. Already the trade account has improved in the third quarter of this year, and a stable rand at current levels will help stabilise the inflation outlook. In addition, the exchange rate adjustments are expected to be positive for export growth, and in conjunction with the adjustment of interest rates should help to ensure that domestic growth is driven by exports and infrastructural investment, rather than by strong consumer spending as has been the case in the past two years.

International investor interest in South Africa has nevertheless remained strong. Despite the repricing of emerging-market assets in the middle of 2006, there has not been one month during the year to date in which non-residents had not been net purchasers of South African bonds and equities. In the year to date, the net amount of bonds and equities purchased by non-residents totals a record of more than R100 billion, compared R41 billion in the whole of last year. Consequently, the current account deficit continued to be adequately financed. Although we are hesitant to become too confident too soon, it also appears as if portfolio investments may be becoming a more stable source of financing, as emerging market assets become a more integrated part of global investment mandates, in particular those like South Africa which have investment grade ratings.

In 2004 and 2005 the South African economy grew at robust rates of 4.8 and 5.1 per cent respectively. This is in sharp contrast to the 3 per cent average annual growth experienced between 1994 and 2003. In the first two quarters of this year, the economy grew at revised annualised rates in excess of 5 per cent. Although the third quarter growth slowed to 4.7 per cent, this is still a very encouraging picture. According to the National Treasury projections, a growth rate of 4.4 per cent is forecast for next year, rising to 5.3 per cent by 2009. Growth is likely to be underpinned by higher infrastructure expenditure. The impact of this can already be seen in the strongly rising investment ratio. These higher growth rates have also had a positive impact on employment growth. According to the latest Labour Force Survey, approximately 1.2 million jobs were created over the 3-year period to March 2006. This is good news indeed.

This positive growth outlook suggests that with an appropriate policy environment, the aims of the Accelerated and Shared Growth Initiative for South Africa (ASGISA) can be achieved, that is, to maintain GDP growth at around 4.5 per cent until 2009 and 6 per cent thereafter. Fiscal policy has remained prudent, to the extent that for the first time ever, provision has been made for a budget surplus in the coming fiscal year. Monetary policy will continue to play its role by providing a low inflation environment.

4. G-20 developments

I would like to turn briefly to our role in the G-20 which South Africa will chair in 2007. The G-20 was established in 1999 as a forum where central bank Governors and Ministers of Finance of developed and systemically important emerging and developing economies deliberate on issues relating to global economic and financial stability in support of global growth and development. The Bank and the National Treasury are currently making the necessary preparations for hosting and arranging meetings and seminars of the G-20 next year and three themes for the 2007 work programme have been identified.

The first theme relates to the reform of the Bretton Woods Institutions. As I have said in the past, these institutions need to be thoroughly examined and overhauled since their modus operandi no longer serves their diverse membership in today’s dynamic global environment. The second theme of fiscal elements of growth and development, or fiscal space, is envisaged to obtain the perspectives of G-20 member countries on how to create and use this fiscal space in support of economic and social objectives. Finally, the third theme will analyse the effects of commodity price changes on G-20 members from a financial stability perspective.

5. Conclusion

As I noted earlier, 2006 has been a challenging year. Going forward, I would venture to guess that 2007 will be no easier. The South African economy should continue on its positive growth path, and the Bank will maintain its focus on keeping inflation under control. We remain committed to our role of providing a stable macro-economic environment which would mitigate the effects of negative international developments if they were to occur.

Should you wish to have a further discussion on South African economic issues tonight, I urge you to engage our senior staff members that have been allocated to all the tables. Finally, please enjoy the rest of the evening, and may you have in the period ahead a wonderful festive season and a prosperous New Year.

Thank you.