A D Mminele: Recent economic developments in South Africa

Remarks by Mr A D Mminele, Deputy Governor of the South African Reserve Bank, at the Citigroup Global Issues Seminar, Istanbul, 4 October 2009.

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1. Introduction

Good afternoon ladies and gentlemen, and thank you to Citigroup Global Markets for providing the opportunity for us to interact and for me to share some thoughts with you on recent economic developments in South Africa.

It has been just over two years since the dawn of the global financial crisis, and just more than 12 months since we all thought the end of the world was upon us when Lehman Brothers collapsed. Financial institutions have written-off more than USD1,5 trillion in losses, governments and central banks around the world have taken unprecedented actions in an attempt to restore stability to financial systems and to prevent the global recession from becoming entrenched. The International Monetary Fund (IMF), the Bank for International Settlements (BIS), and various other institutions have been working tirelessly on several fronts to help countries, closely tracking economic and financial developments, giving policy advice, putting together forums to deal with issues related to regulation and supervision and assisting emerging markets and low-income economies, some of which were innocently caught up in the crisis.

Fortunately, in South Africa's case, there was no need for any unconventional policy measures, and there was no need to focus directly on financial stability issues as the domestic banking and financial system has remained sound. Money market operations continued as normal, and the interbank market has not experienced any difficulties.

In discussing recent developments in South Africa I will limit my remarks to real economic developments, recent monetary policy developments, balance of payments and will also very briefly touch on fiscal policy developments and the state of our banking system. I will be happy to respond to questions, as best as I can, pertaining to other areas that may be of particular interest to you.

2. Real economic developments

Last year this time, I delivered a speech at an investor gathering much like this one. I noted at the time that South Africa had been relatively shielded from the direct effects of the sub-prime crisis. The challenges at that time were mainly around increased financial market volatility, heightened risk-aversion resulting in less portfolio inflows and higher costs for raising capital in international markets. However, it was apparent then already, that as an increasing number of developed and emerging economies moved into recession, South Africa, as a small and open economy, would not be able to avoid the spillover effects thereof. The only thing which was uncertain was the magnitude of the spillover.

Indeed, domestic economic activity had already started to slow on account of tighter monetary policy applied between 2006 and 2008, resulting in slowing domestic demand. However, the real impact of the decline in global growth started to be felt in the fourth quarter of 2008, when for the first time in a decade, the domestic economy contracted. In the first quarter of 2009, the domestic economy officially entered into a recession and a third consecutive quarter of negative growth was recorded in the second quarter of this year. South Africa was somewhat lagging the rest of the world.

Initially, the declines in economic activity were concentrated in the manufacturing sector, but as international conditions deteriorated, the slowdown filtered through to other sectors as

well. The strongest contractions were recorded in the export-oriented sectors. Virtually all sub-sectors of the manufacturing industry were adversely affected and manufacturing output contracted by almost 20,0 per cent in the first half of 2009. Significantly reduced demand for basic metal and mineral products as well as lower international commodity prices weighed heavily on output in the mining sector, which contracted by almost 17,0 per cent. The performance of the mining sector in the first half of 2009 was not that significantly different to the first half of 2008, when it contracted by 11,0 per cent mainly as a result of power supply problems. The tertiary sector was weighed down by a contraction in output by the financial services sector, contracting for the first time since 1992, as credit extension slowed and capital market activity was subdued. Consequently, all three major sectors – primary, secondary and tertiary – recorded negative real growth in the first half of 2009.

It came as no surprise then that the labour market shed jobs on a broad front, but most notably in the manufacturing, construction and mining sectors. Following a period of robust growth between 2004 and 2007, employment in both the private and public sectors increased, pushing the unemployment rate down from 28 per cent in 2004 to 21,9 per cent in the fourth quarter of 2008. In the second quarter of 2009, the unemployment rate unfortunately increased to 23,6 per cent.

The Reuters consensus forecast estimates that the economy will contract by around 2,0 per cent in 2009,[1] before growing at 2,3 per cent in 2010. Based on the composite leading business indicator, which has been increasing for the last few months, we may emerge from the recession later this year. Like in other parts of the world, there is uncertainty as to the strength of the recovery we are going to see.

3. Monetary policy

During 2008 the MPC was more concerned about the generalised nature of the inflation dynamics that were brought about primarily by the succession of supply side shocks. It was only in the latter part of the year that global developments began to have a significant impact on the economy. The contraction in output, and hence the widening output gap, combined with an easing in inflationary pressures, allowed for a change in the monetary policy stance. The MPC also decided to meet more frequently in order to assess the rapidly changing operating environment in a timeous manner and to be able to act appropriately when deemed necessary. Given the lag in the reaction of inflation to interest rate changes, and its focus on the medium to long-term expected inflation trajectory, the MPC decided to reduce the repurchase rate by 500 basis points between December 2008 and August 2009, despite the fact that inflation was still above the upper end of the inflation target range.

At the most recent MPC meeting in September, the repo rate was left unchanged at 7,0 per cent. The MPC is of the view that the risks to the inflation outlook appear to be fairly evenly balanced, and with the current monetary policy stance, the most recent forecast indicates that inflation should return to within the target range on a sustained basis by the second quarter of 2010.

Upside risks to this forecast are mainly high increases in administered prices, above-inflation increases in nominal unit labour costs, as well as to an extent oil price developments. On the other hand factors such as weak consumption expenditure, weakness in credit aggregates, and the relatively strong exchange rate of the rand will provide downside pressure on inflation.

[1] Reuters consensus forecast, August 2009 survey.

4. Balance of payments

The contraction in real gross domestic product and the steep decline in the volume of merchandise imports in the first half of 2009 led to a turnaround in the deficit on the trade account in the second quarter of 2009. South Africa's trade balance, which had registered deficits since the third quarter of 2005, consequently changed from a deficit of R53,4 billion in the first quarter of 2009 to a surplus of R26,6 billion in the second quarter. The contraction in domestic economic activity since the middle of 2008 has also had a positive impact on the deficit on the country's services, income and current transfer account with the rest of the world. Owing to a combination of continued lower net income and other service-related payments to non-residents, the deficit on this account narrowed considerably. As a result, the negative balance on the current account of the balance of payments improved from 7,0 per cent of gross domestic product in the first quarter of 2009 to 3,2 per cent in the second quarter. This deficit was financed through a combination of direct and portfolio investment inflows.

5. Banking sector developments

South African banks have been largely shielded against the direct effects of the global financial crisis. Apart from a sound regulatory framework, reasons were, among others, the fact that domestic banks had not invested heavily in high-risk securities or complex structured products and had very limited foreign credit exposure in their loan books. Not surprisingly, though, the banking sector's operating environment deteriorated, as a result of the adverse economic developments both in South Africa and internationally. This was felt by banks mainly through continuously rising credit impairments. Impaired advances as a percentage of gross loans and advances increased to 5,5 per cent at the end of June 2009 from 2,3 per cent in January 2008. Nevertheless, the weaker asset quality of banks at this stage is not a source of major concern. Banks have maintained high capital levels, with the capital-adequacy ratio for the banking sector amounting to over 13,7 per cent in June 2009, and continued to be profitable, albeit at a lower level.

6. Fiscal policy

As a member of the G20 and in support of the commitments made to address the impact of the financial crisis, South Africa's fiscal and monetary authorities have, like in many other countries, implemented counter-cyclical policies. The prudent management of the public finances during periods of robust growth has created the necessary space for fiscal policy to be expansionary during periods of slower growth.

The expansionary fiscal policy, combined with monetary policy easing, should play a strong role in supporting both short and long-term economic growth and employment creation. In addition continued investment in a broad range of infrastructure should contribute to improving the productive capacity of the economy. The central bank is not overly concerned at this point in time about the impact of expansionary fiscal policy on inflation, as it is suitable given current conditions.

7. Outlook

It would appear that the actions taken collectively and individually in global markets have borne fruit. A number of economies have since moved out of recession and forecasts from the IMF and OECD are looking more encouraging than just a few months ago. How permanent this improvement is, however, remains to be seen. Caution is warranted, nonetheless, as temporary monetary and fiscal stimulus measures may be providing a false sense of security.

As for South Africa, although growth continued to contract in the second quarter of this year, the pace of contraction slowed from -6,4 per cent in the first quarter to -3,1 per cent in the second quarter. The manufacturing sector appears to be turning the corner; the Purchasing Manager's Index seems to be steadily climbing back towards the 50 threshold. Businesses and consumers are also more optimistic as reflected by the confidence indices. The composite leading indicator of the South African Reserve Bank has been increasing during the last three, indicating that a recovery can be expected by the end of the year.

8. Conclusion

In conclusion, there are encouraging signs that the global slowdown may have reached its lower turning point. There remains a high degree of uncertainty attached to the speed and extent of the recovery, however, the swift manner in which authorities reacted have certainly borne fruit. Developments in the South African economy are very much influenced by global economic developments. While we lagged on the way down, it is likely that we will lag on the way up.

Taking cognisance of the global financial and economic environment, and domestic developments with regard to growth, monetary policy will remain primarily focused on inflation management.

Thank you.