Lesetja Kganyago: The global economy and South Africa's challenges

Address by Mr Lesetja Kganyago, Governor of the South African Reserve Bank, at the Conference of the Industrial Development Corporation (IDC), Sandton, 19 October 2015.

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Good morning and thank you for the opportunity to address you at this important milestone in the history of the Industrial Development Corporation.

South Africa's industrial development was initially shaped by mining, but linkages to the rest of the economy spurred the growth of the manufacturing sector. Today, industrial development is still seen as central for economic growth and employment creation in the country. However, South Africa's manufacturing sector is currently facing significant short-term as well as longer-term challenges. Fifteen years ago, the sector accounted for about 18 per cent of GDP, but today its share is 12,5 per cent, with the finance, real estate and business services sector now the single largest sector at almost 20 per cent.

Since the global financial crisis in particular, South Africa's global competitiveness has been deteriorating, as reflected in the country's declining share of world trade. Longer-term constraints to industrial development include the pace of global technological change, the changing nature of global value chains, the lack of appropriate skills, logistics and infrastructural deficiencies as well as rising input costs, to name but a few. These issues will be discussed in some depth by the panels during the course of the day.

My address this morning will attempt to set the scene by focusing on the current global and domestic contexts as well as the challenges that these pose to future industrial development. No discussion about competitiveness is complete without reference to the exchange rate, which is often too easily seen as either the cause of or the potential panacea for South Africa's competitiveness woes. Given its volatile behaviour, the exchange rate is an important focus of monetary policy, and I will make some comments on this issue as well.

The global economic outlook

Allow me to begin with the outlook for the global economy that has not fully recovered from the global financial crisis.

While emerging-market economies recovered relatively quickly from the crisis, recovery in the advanced economies has been hesitant at best. In the past four years or so, we have seen a familiar pattern: one of optimism at the beginning of the year that the global economy will improve, only for these hopes to be disappointed quite early on in the year. More recently, however, there have been convincing signs that some of the advanced economies are well on the road to recovery, particularly the United States and the United Kingdom. But even in these economies forecasts have been scaled down somewhat, particularly after the very weak first quarter in the US. Nevertheless, growth next year is expected to be in line with, or to exceed, estimated potential output growth. Labour-market developments in both economies have been favourable, with the unemployment rate falling to 5,1 per cent in the US. Nevertheless, there is still uncertainty about whether these trends will result in an increase in labour-market participation, which would cause the unemployment rate to increase. And while these economies are improving, it is unlikely that their recovery will be sufficient to take the rest of the world along with it, as the US is no longer the locomotive of global growth that it used to be.

This positive prognosis is not generalised to all the advanced economies, with the euro area in particular still facing significant challenges. While there have been signs of a more sustained recovery in the region recently – particularly in countries such as Ireland, Italy and Spain – growth in the German economy has disappointed. The Greek debt crisis seems to have been averted for now, but the general view is that any re-emergence of the crisis is unlikely to have a systemic impact. The slow pace of recovery in the region is expected to result in a continuation, or even an expansion, of the monetary stimulus from the European Central Bank. The outlook for Japan also remains quite uncertain. The favourable first-quarter outcome was followed by a contraction in the second quarter, and the economy remains dependent on monetary policy support as it battles to get out of its deflationary trap on a sustainable basis.

While recovery in the advanced economies remains patchy but positive overall, the lack of synchronisation in the global recovery is even more pronounced when we look at the outlook for the emerging-market economies. The post-crisis view that emerging markets would replace the advanced economies as the epicentre of global growth has been shaken, despite their important initial role in leading the global recovery. Central to the risks to the outlook has been the slowdown in China, where growth rates have declined persistently in recent years as the economy rebalances away from investment-led growth to a more consumption-led focus. The implications for much of the emerging market and the developing world have been profound, but given the increasingly important role of emerging markets in global economic prospects, the risk of spillbacks to advanced-economy growth prospects has been significant as well.

There are conflicting views as to the extent of the slowdown, the ability of the Chinese authorities to counteract it, and the impact on emerging markets of a rebalancing of the Chinese economy. Despite these concerns, the latest IMF growth forecast for China, as published in the October *World Economic Outlook*, is unchanged since the April forecast, with growth of 6,8 per cent forecast for this year (compared with a forecast of 7,3 per cent in April last year) and 6,3 per cent for 2016. This follows growth of 7,7 per cent and 7,3 per cent in 2013 and 2014 respectively. A number of other forecasters are, however, not as optimistic.

To some extent, this slowdown is to be expected, as the previous stellar rates of growth were unsustainable, particularly as the Chinese economy grows off a larger base. Furthermore, previous growth was predominantly driven by unsustainably high investment ratios in excess of 40 per cent of GDP. Previously, the government policy response to the slowdown was to stimulate investment in the industrial sector and infrastructure. Given the new focus, there is uncertainty about the nature and efficacy of possible policy responses to the current slowdown. Furthermore, if the authorities do manage to engineer a soft landing and persist with a more consumption-led path, there is a great deal of uncertainty as to what the implications of a more services sector-oriented economy would be for emerging markets and commodity prices.

To date, while the measured growth slowdown appears to have been moderate, the impact on other economies has been quite strong. The main impact for South Africa and a number of other economies (not only emerging markets) has been on commodity prices. This is not new; this trend began in 2011 already, but accelerated around the middle of this year. Since the beginning of 2012, for example, platinum prices have almost halved and iron-ore prices are down by about 25 per cent. The IMF estimates that the weak commodity price outlook will subtract about 1 percentage point annually from the average growth rates of commodity-exporting countries from 2015 to 2017, and in energy-exporting economies the impact is expected to be more than double this amount. These developments are reflected in the recent economic performance of Brazil and Russia, both of which are experiencing recessions, India being the only one of our BRICS partners with a strong growth outlook. Although African economies have been experiencing relatively strong growth, some downside revision has been seen in response to commodity-price developments.

Apart from commodity prices, another global factor impacting on South Africa is the prospect of monetary policy tightening by the US Federal Reserve, which has had a significant impact on capital flows to emerging markets. The recovery in the US has prompted expectations of a tightening of monetary policy, and this process effectively began with the phasing out of quantitative easing during 2013. The focus then became the timing and extent of policy interest-rate increases, but successive growth disappointments, very low inflation and uncertain labour-market developments delayed the expected commencement. The ever-changing views on the timing of the so-called ‘lift-off’ have contributed to the uncertainty and volatility in emerging-market exchange rates, with every data point overly scrutinised. For example, the weak US retail data, released last week following worse-than-expected payrolls data, resulted in a sharp weakening of the dollar as expectations of an interest-rate increase were moved out.

That the Fed will tighten is inevitable. The question is one of timing. But the associated uncertainty has affected the financial conditions in many emerging markets, particularly those with current-account deficits. Furthermore, the start of interest-rate normalisation will not do away with uncertainty completely, as the focus will then move to the next meeting. While the Fed has signalled its intent to follow a very moderate path of interest-rate increases, the so-called 'dots', which represent the expectations of FOMC members of future interest-rate moves, have changed significantly from meeting to meeting, reflecting uncertainty even among policymakers.

Emerging markets have therefore been facing a double negative in terms of capital flows: capital which had previously been chasing relatively higher yields and higher growth in emerging markets is now reversing, with the prospect of interest-rate increases in the US. In addition, the lower growth associated with the slowdown in China and declining terms of trade have also contributed to a reversal of capital flows towards the advanced economies. But at the same time, concern about the slowing global economy and its possible spillbacks to advanced economies has also weighed on the Fed's decision making.

Do these developments point to an impending crisis in emerging markets? Some commentators point to parallels with the Asian crisis in 1998/99. The outlook is challenging, but I would not characterise it as a crisis. Emerging markets in general are better equipped today to meet the challenges posed by terms-of-trade deterioration and capital-flow reversals. Macroeconomic frameworks are far more robust, and exchange rates are more flexible to act as a shock absorber to these changes. That is not to say that it will be without pain. Unfortunately, capital flows which could help to cushion the adjustment to deteriorating terms of trade are drying up precisely when most needed. Some adjustment will have to take place, and the exchange rate is an important part of this process.

Furthermore, there are differences between emerging markets which will determine how they are affected by these developments. For example, countries with sizeable current-account deficits will have a different reaction to capital-flow reversals than those with surpluses. And while non-commodity exporters will benefit from lower commodity prices, particularly emerging markets in Asia, these economies are already experiencing a decline in their manufactured exports to China.

The domestic economic outlook

These developments provide a challenging backdrop for the South African economy going forward. Apart from the impact of lower commodity prices, the continued slow growth in the euro area and further risks from a slowdown in Africa constrain the growth in our manufactured exports. In addition, the persistent current-account deficit needs to be financed at a time when capital flows to emerging markets are declining.

South Africa's growth outlook is extremely fragile. Following the disappointing quarter-on-quarter GDP growth outcome of 1,3 per cent in the first quarter of this year, growth surprised on the downside when a contraction of 1,3 per cent was recorded. Of concern was the fact that it was broad-based across sectors, with only the finance, real estate and business services sector showing reasonable performance, recording growth of 2,7 per cent.

At the heart of this low growth is the weak growth trend in gross fixed capital formation. This is particularly true of the private sector, and reflects in part the persistently low levels of business confidence. Total gross fixed capital formation contracted by 0,4 per cent in 2014, with the private sector contracting by 3,4 per cent and public corporations increasing by a mere 1,6 per cent. In the second quarter of this year, private-sector growth was barely positive at 0,1 per cent, the same as that of public corporations. The main area where there has been some growth in private-sector investment in recent years has been with respect to renewable energy. While this is a welcome development, we need more broad-based investment. The weak public-sector investment growth reflects the slow pace of infrastructure expenditure growth, which is central to any industrial development strategy.

One of the main constraints to investment is of course the uncertainty of electricity supply. This has both short- and long-term impacts. Load-shedding affects output immediately, and is reflected in the weaker current GDP growth outcomes. But of greater concern is the longer-term impact that electricity supply constraints have on potential output growth, as forward-looking investment plans are delayed or even shelved because of the lack of guarantees of electricity supply. This constraint has contributed to the decline in our estimate of potential output growth to 1,8 per cent. Clearly, if we want a vibrant and expanding industrial sector, we need to have investment as well as an adequate and reliable supply of electricity. Unfortunately we cannot solve this overnight.

The production-based sectors of the economy have been particularly weak, and face a difficult outlook. The agricultural sector is beset by drought, which resulted in a contraction of around 17 per cent in the first two quarters of this year. The mining sector contracted at an annualised rate of 6,8 per cent in the second quarter, and monthly production data indicate that the third quarter is also likely to disappoint. The manufacturing sector has also experienced two consecutive quarters of contraction, of 2,4 per cent and 6,3 per cent, and the outlook is also constrained although a further contraction is not expected in the third quarter.

The Bank's forecast for growth has recently been revised down by half a percentage point in each year of the forecast period, to 1,5 per cent in 2015 and to 1,6 per cent and 2,1 per cent in the subsequent two years. This weak outlook is consistent with the Bank's leading indicator of economic activity, which has exhibited a more pronounced downward trend in recent months. Apart from the continued electricity supply issues, growth is expected to be constrained by weak private-sector investment and subdued growth in household consumption expenditure amid low levels of both business and consumer confidence.

Competitiveness and the exchange rate

One of the main themes of today's discussions is that of competitiveness. Competitiveness has a number of different dimensions, one of which is the exchange rate, and it is perhaps appropriate for me to say a few words about this, as the exchange rate is of course also of importance from a monetary policy perspective.

Between 2009 and 2011, the rand experienced a strong recovery from the global financial crisis in the wake of strong commodity-price increases and inflows of capital seeking higher yields. This created stress for parts of the manufacturing sector, in terms of both exports and import competition. Not surprisingly, the Bank came under pressure from parts of this sector to weaken the exchange rate. However, since 2011 the rand has followed a relatively volatile depreciating trend, driven by various factors, including the terms-of-trade deterioration, idiosyncratic domestic factors, bouts of global risk aversion (related in particular to the eurozone crisis) and, more recently, the partial reversal of capital flows in anticipation of higher interest rates in the advanced economies.

However, the response of both the manufacturing sector and exports to the weakening exchange rate has been disappointing, although in recent months we have seen tentative signs of current-account adjustment, both through higher export volumes and through lower import volumes. The current-account-to-GDP ratio has been declining steadily for the past four quarters and measured 3,1 per cent in the second quarter of this year, from a peak of 6,2 per cent in the second quarter of last year. In the second quarter of this year, the trade account recorded its first surplus since the final quarter of 2011. Despite these more favourable developments, we expect the current-account deficit to average in excess of 4 per cent of GDP this year and the next.

There are a number of reasons why we would expect a slow current-account response. First, from a competitiveness perspective, it is the real exchange rate that is of relevance: that is, the nominal exchange rate adjusted for inflation differentials (although there are debates as to what the appropriate deflator should be). Because our inflation has generally been higher than that of our trading partners, the real depreciation has been lower than that of the nominal effective exchange rate. Since July 2011, the nominal effective exchange rate has depreciated by almost 40 per cent, compared to a real depreciation of around 20 per cent. We also need to bear in mind that the real exchange rate is a very broad macroeconomic measure, but companies and sectors have different import intensities and different cost structures, so firm- or sector-specific real exchange rates may differ markedly.

Second, the global environment is important. Slow growth in our major trading partners will dampen our export potential as income elasticities are higher than price elasticities. As outlined earlier, our major trading partners are experiencing subdued or declining growth, consequently constraining demand for our manufactured exports.

Third, intermediate goods (including fuel) and capital goods account for about 80 per cent of imports, and these are often tied to capital investment projects. This imparts a degree of rigidity to import volumes. Too often in the past was current-account compression achieved through declining investment expenditure, with adverse implications for employment and growth.

Fourth, there are lags in adjustment, and manufacturers will want to be certain that the more competitive position will be sustained.

Fifth, strikes and labour disputes have periodically affected exports adversely, as was the case in the platinum sector in 2014.

Sixth, for commodity exporters, the exchange rate acts as a cushion for lower commodity prices but it does not necessarily provide an impetus to higher export volumes.

Seventh, there is the possibility that the increased role of global value chains may have weakened the relationship between the exchange rate and trade in intermediate products used as inputs into other economies' exports. This issue is discussed in depth in the latest IMF *World Economic Outlook*. Although the main finding is that the bulk of global trade is still conventional trade, this issue may be relevant in a number of sectors. This may be of particular relevance to the motor industry in South Africa.

Finally, we also need to look carefully at some of our own domestic policies that have the potential to undermine our exports or to counter the favourable impact of depreciation.

So how does the Bank view the exchange rate, and should we try to intervene in the interest of competitiveness? Monetary policy is concerned about the exchange rate because of its potential impact on inflation. As we have outlined in our monetary policy statements, the exchange rate remains one of the main risks to the inflation outlook despite the fact that the pass-through has been relatively muted compared with previous episodes of rand weakness. However, this does not mean that we try to act against rand weakness. Rather, our reaction to exchange-rate changes is focused on the potential inflationary impact of exchange-rate depreciation in conjunction with a range of other variables that may be concurrently affecting inflation, both positively and negatively.

Similarly, we do not try to explicitly lean against rand strength, although we did take advantage of such conditions in 2009–2011 to continue with our policy of accumulating international reserves. However, the view that we prefer a strong rand to a weak rand is not well-founded. Ideally, what we would like to see is an appropriately valued stable exchange rate, one that is not a significant issue for inflation. However, that is in an ideal world. In reality, the exchange rate is buffeted by a number of fundamentals which require adjusting to; in South Africa's case, these fundamentals include commodity-price changes and capital flows.

Over time, we have learned the hard way that trying to 'lean against the wind' in the face of markedly changing fundamentals can be both futile and expensive, and any success in this respect is likely to be short-lived at best. That is not to say that we will never get involved, particularly in the event of liquidity drying up in the market. That said, let me be clear: no amount of central bank intervention, no matter how well intentioned, can prevent an exchange-rate adjustment from aligning with fundamentals. The best contribution that the Bank can make to competitiveness is to ensure that inflation is contained to the extent possible during periods of rand weakness to ensure that the depreciation is real. It is then up to the relevant sectors to take advantage of the increase in competitiveness.

Conclusion

In conclusion, the domestic economy is facing a challenging future. While the global economy is a constraint, it is important that we do not focus on that only and ignore the very real domestic impediments to growth as well as the opportunities. It is too easy to sit back and bemoan the fact that we are hostage to global developments. There are things that can be done, many of which are clearly spelled out in the National Development Plan. We often hear about a focus on infrastructure, but we always seem to under-deliver in this respect. If South Africa wants to develop its industrial sector, it needs to improve its infrastructure apart from electricity. There also needs to be policy coherence and less regulatory uncertainty.

If we are to succeed in reducing unemployment, we must have a growing, competitive economy. Competitiveness is not simply about the exchange rate; it is a multidimensional concept. These dimensions include the quality of goods and services produced, reliability of delivery, reliable and appropriate infrastructure, appropriate technologies, appropriate and sufficient skills, the ease of doing business, and the minimisation of red tape. Our financial sector is regarded as one of the most efficient in the world, and we have a sound legal framework. We need to build on these strengths, but we have to be proactive if we don’t want to fall further behind.

These are some of the issues that will be discussed during the course of the day, and I look forward to the deliberations.

Thank you.