South African Reserve Bank

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The performance of and outlook for the South African economy

Introduction

Ladies and gentlemen, good morning.

Thank you to The Economist for inviting me to come and address you on the topic 'The performance of and outlook for the South African economy'. This is a very pertinent topic, which could not be more relevant at this stage.

Last week, when presenting the *Medium Term Budget Policy Statement*, Finance Minister Gigaba announced that National Treasury had revised its forecasts for domestic GDP[1] growth to 0.7% in 2017 and 1.1% in 2018, an adjustment of 0.6 and 0.9 percentage points respectively, from the projections made in February. These forecasts are in line with those released two weeks earlier by the IMF[2] in its October 2017 *World Economic Outlook*, with the IMF similarly having scaled down its forecasts for South African GDP growth, by 0.3 and 0.1 percentage points for 2017 and 2018 respectively.

[1] gross domestic product
[2] International Monetary Fund

Describing government's view of the economy, the former US[3] President Ronald Reagan once put it this way: "If the economy moves, tax it. If it keeps on moving, regulate it. And if it stops moving, subsidise it." In my view, almost every economy has been through all these phases – and South Africa is currently moving, albeit at a relatively much slower pace than we would all like, and would be required to address the challenges of unemployment and inclusive economic development.

The slack in growth is perhaps the most crucial economic issue in South Africa at present. Indeed, when it downgraded South Africa's sovereign credit rating in June, ratings agency Moody's listed 'reduced growth prospects' as one of the three key drivers of the downgrade. Yet at the same time, most observers of the global economy concur that the world's economic and financial situation is more favourable than it has been for years.

So why is South Africa missing out on the global recovery? What has driven the poor performance of the past few years? Will this trend continue? If so, what role can the South African Reserve Bank (or SARB) can play in making a contribution to address the issue? These are the questions that I will attempt to answer in my address today.

When activity is volatile but broadly underperforming

The ability to analyse trends in the South African economy has been complicated of late by the high volatility in quarterly GDP data. The standard deviation of the quarter-on-quarter seasonally adjusted change in GDP has been close to 2.0 percentage points, on average, over the past five years. To some extent, this volatility makes it difficult to use the latest data point as an indication of a trend or to determine 'in real time' inflections in the pace of activity. For example, data for the fourth quarter of 2016 and the first quarter of 2017 showed that the South African economy was in 'a technical recession', with two consecutive contractions, however marginal they may have been. This was followed by a rebound of 2.5% in the second quarter.

[3] United States

Surprisingly enough, this short-term volatility was not limited to those demand components which, like public-sector investment or inventory changes, regularly experience large deviations from the trend. Rather, it extended to generally more stable aggregates, for example the household consumption of services. At this stage, it is difficult to say to what extent this volatility reflects changes in household-sector behaviour or data measurement challenges. What we can assume, however, is that the underlying trend of the economy is somewhere 'in-between' the latest observations. We may not be in a recession, but it is quite doubtful that the 2.5% momentum of the second quarter can be sustained.

It seems pretty certain that South Africa is presently mired in very low growth. Following an increase of only 0.3% in GDP last year, our models project a meagre expansion of just 0.6% in 2017. These numbers continue to fall short of the domestic population growth of around 1.5%. This means that, in per-capita terms, GDP is declining and is likely to drop back this year to levels last seen in 2011. Effectively, real GDP per capita will only have grown by 4% overall over the past 10 years, compared with a growth of 20% over the previous 10 years.

Furthermore, as mentioned earlier, South Africa seems to be 'missing out' on the global recovery. Because we are an open and relatively small economy, with commodity-dependent exports and hence terms of trade that are highly sensitive to global industrial demand, our domestic cycle generally moves 'in sync' with its global counterparts. South Africa entered and exited the 2008-09 global recession with a slight delay, but more or less at the same time as most of the world's largest economies. Such cyclical patterns are largely unavoidable, and the best that macroeconomic policy can do is to limit their magnitude and hence their potential distortionary effects.

What is worrying, however, is that while the gap between South African and world growth hovered at around zero just before and during the global recession, this growth gap has gradually widened ever since. It has averaged 1.8 percentage points in the last five years, stood at 2.9 in 2016, and – based on the IMF's and the SARB's forecasts – could increase to 3.0 in the current year. A similar observation arises when comparing South Africa to its upper-middle-income peers[4]: in 2002-07, domestic growth was, on average, 0.4 percentage points below this group's median; last year, the gap had widened to 2.5 percentage points.

Not 'a traditional recession' but 'a slow grind to a halt'

How can we explain this lacklustre performance of the South African economy? And how can we explain its underperformance versus its peers?

In many ways, the downturn of the past few years does not display the traditional characteristics of a recession. For example, there was no build-up of inflationary pressures that necessitated the shift to a restrictive, demand-constraining monetary policy. Inflation has displayed a rising trend since 2011, resulting in the Monetary Policy Committee of the SARB raising the repurchase rate by 200 basis points between January 2014 and March 2016. But by our own, admittedly imprecise, calculations, the real interest rate remained below its neutral level for most of that period. This would suggest that while monetary policy provided less stimulus, it did not turn outright restrictive.

Equally, we did not see the kind of asset-price bubbles or the build-up of other financial vulnerabilities which typically precede a recession, as the unwinding of such imbalances generally results in lower private-sector appetite for borrowing, tighter lending standards by banks, and a rise in precautionary savings by households. In recent years, in part thanks to the generally accommodative stance of monetary policy, banks' non-performing loans have declined, the number of home repossessions has equally fallen to low levels, and while equity prices have performed strongly, home prices have broadly stagnated in real terms.

Admittedly, growth in loans and advances to the private sector slowed in 2016, from almost 9% year on year in late 2015 to a low of 4.5% in November last year. Yet this deceleration proved milder than in previous downward phases of the business cycle. Confidence in the retail banking sector, as measured by the EY Financial Services

[4] This refers to the World Bank's definition of 'upper-middle income', which comprises 56 countries.

Index, remains above par, in contrast to the other major sectors of the domestic economy. Civil cases for debt and insolvencies are below the average of the past decade, even though surveys show that consumers are feeling increasingly vulnerable.[5] As for the savings ratio of households, while it rose from -2% of disposable income in 2013 to around 0% thus far in 2017, it is only back to the levels last seen after the global recession in 2008 and remains very low by historical standards.

Rather than 'a traditional recession', then, what South Africa experienced was 'a slow grind to a halt' that was driven more by long-term supply factors than by long-term demand factors. Admittedly, several external factors, besides short-term domestic disruptions, contributed to the weakness in GDP growth.

The recovery in world demand since the global financial crisis has been sluggish and has displayed low trade intensity by historical standards. For example, the average annual real import growth in South Africa's export markets – as measured by the OECD[6] – amounted to only 3.0% in the last five years and 2.1% in 2016, compared to the 8.6% in the five years leading up to the global recession.[7] And this was not just a volume story: the prices of domestic commodity exports also fell, resulting in a decline in South Africa's terms of trade by 7% between 2011 and 2014.

On the domestic front, the drought that affected South Africa over the 2015/16 summer season resulted in an 8% contraction in agricultural output last year, which shaved off 0.2% from the 2016 GDP growth. Safety-related stoppages also affected mining production in 2016.

Yet both these external and domestic factors do not explain the full extent of the economic slowdown. Nor do they explain why our domestic economy, in contrast to many of its peers, has failed to get much traction in the first half of 2017. After all, the end of the drought, together with the improving global environment and the recovery

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[5] For example, the Consumer Financial Vulnerability Index (computed by the Bureau of Market Research, the University of South Africa, and Momentum) showed a significant deterioration in the second quarter of 2017.

[6] Organisation for Economic Co-operation and Development

[7] The OECD calculates export market growth for a specific country as the weighted average of import growth in its trading partners, with the shares of these partners in the country's total exports as weights.

in South Africa's terms of trade from the second quarter of 2016 onwards, was expected to engineer at least some economic rebound – but so far it is missing.

Most likely, the key to this lack of growth resides in a self-reinforcing 'negative feedback loop' of policy uncertainties, low private-sector confidence, subdued investment in productive capacities, and poor competitive performance. Causality implications between growth and confidence go both ways. Attempts by our in-house research to identify the possible causes of the ever-widening gap between South African and world growth have found that the negative impact of low confidence has increased in recent years, explaining as much as 1.15 percentage points of that gap in 2016.

In turn, weak business confidence amid disappointing demand performance has depressed private-sector fixed investment. Last year, it contracted by 6.8%. As of the second quarter of 2017, it was down by 2.7% year on year and stood at 11.8% of GDP compared to a high of more than 15% at the start of the global recession – its lowest level since 2004. In an environment of low consumer confidence and a lack of property price growth in real terms, the housing sector does not remain immune to such subdued performance. Because of such softness in capital formation, as well as subdued productivity growth, the potential pace of GDP growth has slowed to an estimated 1.1% in both 2016 and 2017 from more than 3% at the start of the decade.

Weak private-sector investment, currently focusing mostly on replacing obsolete capital rather than creating new capacities, coupled with a shortage of skilled labour and, possibly, product market rigidities, appears to be weighing on external competitiveness and export performance. South African firms may be slow to adjust to changes in global demand patterns; they may lack the innovative edge to keep pace with foreign competitors. While the causes may be uncertain, the fact remains that, over the past decade or two, South African export volumes have consistently fallen short of the demand in its trading partners, implying a loss of market share.[8] A trend towards real exchange-rate depreciation has not helped. In fact, market share often

[8] The OECD's measure of export market growth for South African goods and services shows average annual growth of 5.0% since 2010. Over that same period, though, the average annual growth in South African exports has only been 2.2%.

stagnated in the aftermath of rand-depreciation phases but it declined when the local currency recovered.

Most likely scenario: a modest recovery

The question remains: will economic stagnation persist in South Africa? There are presently some grounds for very prudent optimism for the next year or two.

The external economic environment has improved. Last month, the IMF again revised upwards its forecast for world growth in both 2017 and 2018, by 0.1 percentage points in each case, to 3.6% and 3.7% respectively, up from 3.2% last year. Such upward revisions mark a welcome break from the pattern of earlier years, when forecasters regularly pushed back the timing and the scale of the global recovery. Furthermore, this recovery is relatively broad-based, both geographically and across sectors, and it is not generating the kind of price pressures that would prompt the major central banks to aggressively tighten monetary policy and, as such, curtail that recovery.

Closer to home, the decline in inflation over the past year has provided some breathing space to the consumer, allowing some gains in real disposable income despite net job losses. Equally, the decline in the current account deficit, to 2.2% of GDP on average in the first half of the year from as high as 5.9% of GDP in 2013, is helping (together with an elevated global-investor appetite for higher-yielding government debt) to shelter domestic financial markets from external or local shocks. This explains, in part, why the rand and domestic bonds have not shown a strong or durable reaction, this year, to adverse political or policy news.

In recent months, some domestic high-frequency data have shown signs of improvement. Following a downward trend lasting more than three years, new vehicle sales, expressed in seasonally adjusted terms, rose by 10% in September from an April low. Manufacturing production, which had stagnated for the past five years, increased in both July and August to its highest levels in more than a year. The rebound in the mining sector has been even more pronounced. It would therefore appear that both sectors will contribute positively to GDP growth in the third quarter of this year. The RMB/BER[9] business confidence index, while still well below the neutral 50 mark, rose off eight-year lows in the previous quarter.

However, all this is no cause for premature celebration. Many factors still limit the room for a meaningful improvement in South African economic growth. Confidence remains highly vulnerable to upcoming political events given their potential implications for important government policies; it also remains vulnerable to the risk of further sovereign credit rating downgrades. A further rise in the oil price could boost inflation and undermine the terms of trade. And the extent of the impact that the normalization of monetary policies in the advanced economies could have on emerging-market assets, including the rand and domestic securities, is still unclear.

Even in a relatively favourable scenario – where confidence gradually improves, inflation remains moderate, and the output gap gradually closes – structural factors are likely to limit the scope for a meaningful growth pickup. Productivity performance remains weak, with an average annual gain of only 1.2% in the past five years. The shortages of skilled labour are likely to remain acute for an extended period of time even if educational outcomes improve. Job-searching costs are high, making it that much more difficult for low-skilled people to find employment. And the relatively high concentration in many sectors, together with elevated regulation, results in barriers to entry for new firms.[10]

Consequently, even with the gradual removal of infrastructure bottlenecks – for example, as more power supply comes on stream – it is difficult to envisage much of a pickup in potential growth in the next two years or so. For these reasons, the SARB projects only a moderate acceleration in actual real GDP growth, from 0.6% this year to 1.2% in 2018 and 1.5% in 2019.

How can monetary policy help?

How should monetary policy respond to such a situation? Conventional wisdom may argue that, in the wake of a slowdown, interest rates should be reduced so as to

[9] Rand Merchant Bank / Bureau for Economic Research
[10] See *OECD Economic Survey: South Africa, 2017*.

rekindle domestic demand. The SARB is cognisant of the fragile economic situation, and to the extent that its decisions remain consistent with its mandate of ensuring price stability, it takes appropriate actions to support economic activity. The 25 basis points cut in the repurchase rate in July, which had been made possible by an improvement in the inflation outlook, illustrates this approach. However, an aggressive easing of monetary policy – for the sole purpose of kick-starting the economy – could yield disappointing returns for an unacceptable degree of risk, for the following reasons.

First, as I have mentioned earlier, monetary policy was not tight at the start of the downturn, nor was that downturn the consequence of restrictive financial conditions. In recent years, South Africa's monetary stance merely moved from loose to roughly neutral. Surveys and economic data support this assessment: fewer businesses than usual report the level of interest rates as an obstacle to expansion – in contrast to political uncertainty, which has grown as a constraint in recent years. Equally, at 9.4%, the ratio of household debt-servicing costs to income is in line with long-run historical norms.

Second, because the downturn reflects non-monetary factors, it is doubtful how much rate reductions, at present, would stimulate demand. The experience of the advanced economies since the most recent global recession shows that if conditions are not met for a rise in private-sector willingness to borrow, rate cuts are likely to have limited influence on credit and demand growth. For example, if the main concern of many businesses is a lack of policy and regulatory clarity, it is doubtful whether lowering the cost of capital will entice them to invest. Equally, risk-averse households may use lower interest rates to ensure a faster repayment of their debt rather than increasing their expenditure or investing in new residential property.

Third, even if demand were to respond to meaningful interest-rate cuts, the economy's supply constraints might soon limit its ability to meet the increase in demand, resulting in higher prices either directly or indirectly via a rise in imports that would widen the trade balance and depreciate the exchange rate. Domestic demand in South Africa – and this includes household consumption as well as fixed investment – has always been import-intensive, even in periods of prevailing economic slack. And while our estimates of the output gap point to some degree of slack in the economy, others (such as capacity utilization in manufacturing) paint a more ambiguous picture.

Fourth, the risks to the inflation outlook appear presently too skewed to the upside to allow the SARB to embark on a sizable monetary stimulus without fears of a sustained overshoot in the inflation target range. Ongoing careful assessment of evolving data and vigilance continue to be imperative. Our own models suggest that, because of the rigidities in the domestic wage and price formation process, the output gap does not have a large impact on inflation trends. By contrast, the sensitivity to changes in the rand, which could easily depreciate in the event of sizable rate cuts, is generally higher, even if it appeared to decline in recent years.

Conclusion: the merits of a stability-oriented framework

Nevertheless, monetary policy does have a role to play in attaining stronger, more sustainable economic growth in South Africa. However, it remains the SARB's view that the best way it can assist in reaching this goal is by fostering medium-term price stability so as to minimise the distortionary effects of a volatile inflation. In particular, historical evidence – both in South Africa and abroad – suggests that when price expectations are better anchored, any shock to inflation is more transient and hence allows the central bank greater latitude to quickly respond to a slowdown in real economic activity.

South Africa's inflation-targeting regime is bearing fruit in that respect. Inflation expectations (as measured by the BER[11] survey of analysts, businesses, and trade unions) are currently better anchored than in the early years of the inflation target range. This, in turn, has resulted in more moderate fluctuations, both in the short-term and in the long-term interest rates, over the economic cycle. The SARB remains concerned, however, that these expectations have become too closely anchored around the upper end of the 3-6% target band. Not only does this raise the risk that any shock to prices will result in a durable overshoot of the target range; it also leaves South African inflation structurally higher than in most of its trading partners. This

[11] Bureau for Economic Research

means that external competitiveness can only be maintained through a regular weakening of the rand, which perpetuates a cycle of inflation and exchange-rate depreciation that probably adds to the risk premiums in financial assets and, in turn, unnecessarily raises the cost of capital.

In fact, international experience suggests that, since they have adopted a similar regime, most of the other emerging countries that have managed to keep a lower rate of inflation than South Africa have also enjoyed a stronger rate of economic growth. Looking at a dozen or so large and open emerging economies with an inflation-targeting regime, we find that the sample's median GDP growth (since the adoption of the regime) has been about 0.5 percentage points higher than South Africa's whereas its inflation rate has been about 2.0 percentage points lower. If anything, the growth gap is even bigger in the years since the global financial crisis.

In conclusion, it would appear that the economic difficulties that South Africa is currently facing are not an indictment on the monetary-policy framework that has been followed for the past 15 years or so. Rather, they illustrate that even a well-calibrated monetary policy cannot, on its own, address the economy's structural challenges. Of course, monetary policy is always perfectible; its framework can evolve as underlying economic structures change. And the SARB remains committed to constantly looking for ways of carrying out its mandate better.

But at the end of the day, a central bank has too few tools at its disposal to solve the large number of problems that we are currently facing – both here and abroad. This brings to mind the words of James Penney, businessman and entrepreneur: "Growth is never by a mere chance, but it is a result of forces working together."

Thank you.