T T Mboweni: Recent economic and financial developments in South Africa

Address by Mr T T Mboweni, Governor of the South African Reserve Bank, at a luncheon of the South African-German Chamber of Commerce and Industry, held in Johannesburg, on 10 October 2000.

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1. Introduction

World economic activity expanded at a rapid pace during 1999 and the first nine months of 2000. Forecasts for the growth in global production by the major multilateral institutions for the year 2000 generally vary from 3½ to 4½%. Moreover, the strengthening in world economic activity was fairly broadly based, except for Japan which had negative growth in 1999. However, from the beginning of 2000, Japanese economic growth started to pick up together with a rise in corporate profits and fixed investment in the private sector.

Nearly every other region of the world has seen an improvement in economic performance during the past year. Many of the world's poorest countries, including some in Africa, are recording respectable growth rates. Growth in Europe has picked up remarkably and the United States is enjoying the longest expansion it has ever recorded. The remarkable economic boom in the United States has undoubtedly made an important contribution to the strength of the recovery in the world. But so too have the achievement and maintenance of price stability around the world. Despite a substantial rise in oil prices and strong international demand, inflation in nearly all the industrial countries has remained subdued since the beginning of 1999.

2. Slow economic growth in South Africa

In this buoyant economic environment it is rather surprising that the South African economy did not perform better. The high international economic growth was expected to assist growth in the South African economy through increased demand for exports, higher prices on commodity markets and increased investments. After showing clear signs of a vigorous economic recovery during 1999, the economic growth in South Africa slowed down in the first half of 2000. The annualised quarter-to-quarter growth in the seasonally adjusted real gross domestic product at first accelerated from ½% in the fourth quarter of 1998 to 3½% in the fourth quarter of 1999. Contrary to general expectations, it then declined to 1% in the first quarter of 2000 and 1½% in the second quarter.

The low economic growth during the first half of 2000 was largely due to a decrease in agricultural output that amounted to 7% after adjustment for seasonal factors and annualised. Torrential rain and flooding affected agricultural production in the northern and eastern parts of the country, and high temperatures and veld fires in the south-western wine and deciduous fruit producing areas caused extensive damage to crops. On top of this, farmers could not harvest the maize crop in the second quarter of 2000 because of the generally wet conditions. Maize output was therefore shifted to the third quarter of 2000 and should be an important plus factor for higher growth in the second half of the year.

Economic growth in South Africa during the first half of 2000 was also negatively affected by an oversupply of coal on international markets, so there was less demand for one of South Africa's important export commodities. Gold output continued to fall, contributing to a further decline in the value added by the mining sector. In addition, manufacturing output was affected by negative business sentiment related to the depreciation of the rand, volatile conditions in financial markets and socio-political developments in some sub-Saharan African countries.

Many of these negative factors now seem to have improved, calmed down or disappeared completely. The outlook for economic growth is accordingly much more favourable. Higher growth rates could probably be expected during the second half of 2000 and in 2001. Prospects for long-term production growth, however, are still somewhat bleak in view of the current low fixed investment ratio. Fixed capital formation of about 15% of gross domestic product is not enough to sustain a high rate of output growth and job creation. High sustainable economic growth can only be obtained if there are larger additions to the production capacity of South Africa and increased productivity.

We not only need to work harder, we also need to work smarter. Since 1994 there has been a marked improvement in labour productivity. In the past five years the growth in production per worker in the non-agricultural formal sector of the economy has averaged more than 3½% per year. These increases in labour productivity were, however, obtained by substituting new fixed investment to replace labour, rather than by expanding the productive base of the economy. Multifactor productivity, in other words the combined productivity of labour and capital, grew far less impressively than labour productivity alone.

According to the findings of the 1999 October Household Survey of Statistics South Africa, employment increased in the year to October 1999. This finding is based on a broader definition of employment, namely employment in the formal sectors including agriculture and some self-employed persons as well as the workers in the informal sector. This survey shows that the overall number of jobs in the economy increased by about 10% to a level of around 10.4 million over the 12 months up to October 1999. The number of unemployed people remained unchanged over this period, resulting in a decline in the official unemployment rate. The official rate measures the unemployed as a percentage of the economically active population. This rate declined from just more than 25% in October 1998 to about 23% in October 1999.

According to this survey, South Africa was therefore able to provide work to its growing population and to reduce the number of unemployed people, even at relatively modest economic growth rates. One should, however, immediately add that a large proportion of the increase in employment took place in the informal sector of the economy, meaning in the segment of the economy that has a low potential for rapid growth. Development in the South African economy is currently taking place in low-growth sectors with low fixed investment. At the same time, our savings ratio has declined to about 16% of gross domestic product.

Despite the important structural changes that the government has undertaken and the sound macroeconomic policy measures that have been applied, the economy still is not poised to obtain high sustainable economic growth. This objective will require further adjustments to make the country even more investor friendly, to attract direct foreign investors and to counter any negative socio-economic issues. When determining policy, careful consideration is given to factors that could improve the general business mood and investments in South Africa.

3. Financial stability

Some people also believe that we need lower real interest rates in South Africa if we want to achieve higher fixed investments and sustainably high economic growth. This is, of course, a valid argument. At low interest rates, the user cost of capital is lower and business people would be more inclined to invest their money in risky but probably lucrative capital projects. In this way the fixed investment ratio of the country would be increased, leading to higher growth and more employment opportunities.

If only the real world was that simple, how easy my task would be as Governor of the Reserve Bank. Unfortunately, it is well known that a lenient monetary policy with low interest rates and the creation of money, does not lead to higher economic growth. The old adage is still true, it is like "pushing on a string". Creating more money only leads to higher inflation. If it was so easy to achieve higher economic growth, there would be hardly any poor countries left in the world.

I know that I am ridiculing the argument for lower real interest rates. Naturally, it is not easy to determine where the correct level of real interest rates should be to achieve high economic growth and maintain price stability. It should, however, be realised that the interest rate is the price for money. The

Reserve Bank can only influence short-term interest rates through the application of monetary policy operational procedures. Although shorter-term interest rates influence the level of longer-term interest rates, other factors are also important when determining these rates. For example, at times you may find that the Reserve Bank reduces the repo rate, which lowers money market interest rates but leads to higher longer-term interest rates because of expected higher inflation. The Reserve Bank therefore only has an indirect influence on the level of the long-term interest rates that affect investor decisions.

Moreover, the Reserve Bank cannot arbitrarily set short-term interest rates without taking careful note of underlying economic and financial conditions, and it is not the function of the Bank to promote economic growth in an artificial manner. At most, the Reserve Bank can only create stable financial conditions, which are generally regarded as an important precondition for high sustainable economic growth.

This we have attempted to do over the past decade in a way that would have the least harmful effect on real economic activity. The policies followed by the Bank, together with fiscal and other policy measures, succeeded in creating greater price stability in South Africa. In 1998 and 1999 the rate of increase in the consumer price index excluding mortgage interest costs (CPIX) averaged 7% a year. This rate of increase can be compared with inflation rates fluctuating around 15% in the 1980s and early 1990s.

The endeavours of the Reserve Bank to create these stable financial conditions were at times seriously hampered by exogenous shocks, particularly by volatile capital movements. In the past year we were again influenced dramatically by this volatility in foreign portfolio investments in South Africa. Non-resident investors sold large amounts of domestic securities because of socio-political events in Africa, a shift of funds away from commodity-based countries to high-technology and manufacturing-oriented economies, a rearrangement of portfolios as a result of surging energy prices and higher international interest rates. After being net investors in South African bonds to the amount of R16.5 billion from the beginning of 1999 until the end of January 2000, non-residents became net sellers of bonds totalling R15.3 billion in the next six months up to the end of July 2000. Moreover, the net purchases of shares by non-residents on the Johannesburg Stock Exchange fell from R40.6 billion in 1999 to only R6.8 billion in the first seven months of 2000.

Non-residents' net sales of bonds then changed to net purchases of R2.8 billion in July and August, before they again became net sellers to the amount of R5.2 billion in September 2000. Fortunately, over the same three months, they remained large net purchasers of South African shares on our stock exchange. These purchases amounted to R9.2 billion, which neutralised their sales on the Bond Exchange.

These substantial fluctuations were recorded in the financial transactions of South Africa, despite a fundamentally sound balance of payments position. Although the current account of the balance of payments moved into a deficit from the second quarter of 1999, the deficit remained relatively small. Throughout 1999 and the first half of 2000 the deficit did not exceed ½% of gross domestic product, and in the second quarter of 2000 a surplus of R5.7 billion at a seasonally adjusted and annualised rate was recorded. This surplus was a remarkable achievement taking into account the substantial increase in the country's oil import bill. The bigger bill was due to a rise in the price of oil from about US$ 10 per barrel at the beginning of 1999 to prices in excess of US$ 30 in the first half of 2000. The strong performance of the current account can largely be attributed to the growth in merchandise exports which neutralised increased imports. The favourable economic conditions in the world, a rise in international commodity prices and a competitive exchange rate level in South Africa led to a considerable increase in both the value and the volume of exports.

As a result of this fundamentally sound balance of payments situation, the gross gold and other foreign reserves of the country have increased substantially. At the end of 1998 the total foreign reserves of the country amounted to R42.1 billion, which was equivalent to the value of about 10 weeks' imports of goods and services. At the end of June 2000 the total foreign reserves amounted to nearly R70 billion, or to 17 weeks' imports of goods and services. Moreover, the utilisation of foreign credit facilities to boost gross foreign reserves was marginally reduced over this same period, indicating that the Reserve Bank did not borrow funds abroad to support the level of the foreign reserves.

4. Exchange rate of the rand

In these circumstances one would have expected the external value of the rand to be strong, and indeed this was the case during 1999. The nominal effective exchange rate of the rand in fact increased by 0.6% from the end of 1998 to the end of 1999. This strengthening of the rand was boosted by the listing of prominent South African companies on the London Stock Exchange which encouraged a large net inflow of portfolio capital. Only in the middle of 1999 was the strengthening of the rand interrupted for a while when problems in Latin America and a steep decline in the gold price led to a sharp depreciation of the rand. This lasted only for a short time and the rand, on balance, strengthened again during the last half of the year.

From the beginning of the year 2000, the rand at times came under severe pressure. It has depreciated against the United States dollar from a level of R6.15 to the dollar at the end of 1999 to a level fluctuating between R7.20 to R7.30 to the dollar in the last week of September. This represents a depreciation of nearly 18%. The rand generally also depreciated against most of the other major currencies, but to a much lesser extent than against the dollar. As a consequence, the weighted average value of the rand declined by about 7% during the first nine months of 2000. This decrease was much higher than the inflation differential between South Africa and its main trading partners and competitors. After adjustments for these price differentials, the rand probably declined at a roughly estimated 3% in real terms over the same period.

The weakness of the rand was largely related to developments outside the borders of South Africa. In particular, the exchange rate of the rand was seriously affected by the strength of the US dollar. The general weakness of currencies against the US dollar is demonstrated by depreciations of almost 14% for the euro, 10% for pound sterling and 20% for the Australian dollar from the beginning of the year until the end of September 2000. The strength of the dollar was related mainly to the exceptionally high and sustained growth in the United States, which encouraged long-term investments from Europe and Japan to flow into America.

The recent sharp depreciation of the euro against the dollar led to a coordinated intervention by central banks in the United States, Britain, Europe and Japan to support Europe's ailing currency. It has been estimated that the central banks of these countries spent about US$ 3 billion to US$ 5 billion to buy euros in the last week of September. As a result the euro's value against the dollar promptly rose from below 85 cents to around 90 cents. Subsequently it has fallen back again and was trading between 85 cents to 90 cents at the beginning of October. Although it did have this immediate impact, it is doubtful if this one-off intervention will have the desired effect over a longer time period. Intervention normally only works if it is aimed at stopping speculative capital flows, if it signals a change in underlying policies, if it is strongly supported by all parties participating and if the central banks are prepared to intervene repeatedly and in large amounts.

These are also the main reasons that the South African Reserve Bank did not intervene in the foreign exchange market. In fact the Reserve Bank has continued to buy small amounts of dollars in the market to improve its net oversold open position in foreign exchange. After this position had improved from US$ 23.2 billion at the end of September 1998 to US$ 10.3 billion at the end of March 2000, the Bank continued to bring this position down slowly to US$ 9.6 billion at the end of September 2000. This was part of the Reserve Bank's objective to reduce its net open position in foreign exchange to zero, in order to remove one of the perceived risk factors in the economy. Any intervention in the foreign exchange market to support the exchange rate of the rand may well have made the downward pressure on the value of the rand worse, in view of this risk factor. The success of such intervention would in any case have probably also been thwarted by the general strength of the US dollar.

5. Concluding remarks

As could be expected, the depreciation of the rand and the substantial rise in energy and food prices affected price increases in South Africa. For example, the year-on-year increase in the CPIX accelerated from 6.5% in October 1999 to 8.2% in August 2000. If fuel and food prices are excluded, CPIX inflation declined slightly from 6.8% to 6.6% over the same period. Similarly, the year-on-year

increase in production prices accelerated from 5.7% in September 1999 to 10.1% in April 2000, and then declined slightly to 9.3% in August 2000. However, if energy and food priced are omitted, the year-on-year increase in production prices has continued to accelerate from a low of 3.2% in November 1999 to 5.3% in August 2000. This upward trend was mainly due to increases in the prices of imported goods, while domestically generated inflation has shown a declining tendency from April 2000.

Despite the upward pressures on domestic prices arising from the depreciation of the rand and the rise in the prices of energy and food, the Reserve Bank resisted the temptation to increase interest rates. Instead, the Bank pursued a policy to encourage stable money market rates in order to restrain the effects of volatile financial markets on the real economy. Under the circumstances, a rise in interest rates would not have countered the effects of supply side shocks on domestic prices. The domestic fundamental factors for inflation also remained favourable. These include seven main factors:

(i) a further slowdown in the year-on-year rate of increase in nominal unit labour costs from an already low 4.5% in the second quarter of 1999 to 2.2% in the second quarter of 2000;

(ii) surplus production capacity in the economy, as reflected by the utilisation of production capacity in manufacturing of only about 79% in the first quarter of 2000.

(iii) no signs of excessive growth in demand, with domestic final demand increasing only at a seasonally adjusted and annualised rate of 2½% and a surplus on the current account of the balance of payments in the second quarter of 2000;

(iv) a sluggish growth in money supply of 8.6% over the 12 months to August 2000;

(v) a low year-on-year rate of increase in total domestic bank credit extension of 7.1% in August 2000 and no signs that consumers have become willing to borrow excessively;

(vi) continued prudent fiscal policies with government carefully monitoring expenditure; and

(vii) signs that the rate of increase in food prices seems to be levelling off.

All these factors indicate that the inflation target of the authorities will be attained in 2002. The Reserve Bank will nevertheless continue to carefully monitor underlying economic developments, and will not hesitate to take the necessary steps if changed circumstances do indicate a danger that the inflation targets may not be met. We remain fully committed to meeting our inflation target of 6-3% of CPIX by end of calendar year 2002.