T T Mboweni: Recent economic developments

Speech by Mr T T Mboweni, Governor of the South African Reserve Bank, at the dinner for Heads of Foreign Missions, Pretoria, 1 December 2003.

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1. Introduction

Dean of Diplomatic Corps - Ambassador Alzubeidi
Members of the Diplomatic Corps, Ambassadors and High Commissioners
Representatives of: the United Nations System - Mr Ohiorhenuan
The European Union - Ambassador Lake
The International Labour Organisation - Dr Andoh
The World Bank - Mr Omar
Foreign Affairs - DDG: Africa, Ambassador Mamabolo
Management & Staff of the South African Reserve Bank
Ladies & Gentlemen

As a relatively open developing economy, South Africa was again affected considerably by world economic conditions during the past year. The weak and fragile global economic recovery impacted on domestic economic growth, low world inflation contributed to a decline in domestic inflation and substantial financial inflows led to a further recovery in the external value of the rand.

2. International economic developments

Global economic activity suffered a setback in the second half of 2002 when business confidence was detrimentally affected by revelations of corporate accounting malpractices, a further decline in stock exchange prices and a threat of war against Iraq. In the first half of 2003 equity prices began to rise somewhat and the war in Iraq was concluded without severely impacting on oil production. Yet the international economy continued to move at a sluggish pace, with the result that most analysts downgraded their initial forecasts for world growth in 2003.

More recently there have been encouraging signs that the macroeconomic environment has improved somewhat. Production growth in the United States of 8,2 per cent in the third quarter of 2003 seems to confirm that the much-anticipated economic recovery is gaining momentum. This acceleration in the pace of growth impacted favourably on the demand for labour, causing the US unemployment rate to edge lower to 6 per cent in October 2003. The real gross domestic product of Japan also increased at stronger-than-expected rates during 2003, while growth in China remained high. A strong domestic demand, improved export performance and fiscal and monetary policies in the rest of Asia are expected to support growth in the rest of this continent.

In contrast economic activity in the euro area was weaker than expected in the second quarter of 2003, but indicators for this region indicate that economic activity could firm somewhat in the coming months. Rising net exports and real exchange rate developments are expected to lead to a modest recovery in Latin America.

Global inflation remains low and monetary and fiscal policies were eased in most advanced economies during the past two years. However, with the recent acceleration in economic growth, some authorities have begun with a less lenient policy stance. The Reserve Bank of Australia and the Bank of England have both recently increased their official central bank rates by 25 basis points. Both central banks cited the pickup in economic activity and increasing household borrowing as the main reasons for the tightening in their monetary policy.

An important further characteristic of the global economic environment in the past two years has been a considerable weakening in the external value of the United States dollar. In particular during the current year this has affected the currencies of most developing countries because of substantial financial inflows into these countries.

3. Domestic production and expenditure

Although domestic growth is expected to benefit from the improvement in the global economic environment in the coming months, the weakness in international economic growth impacted severely on domestic production. Having recorded a high rate of 5 per cent in the second quarter of 2002, real output growth in the South African economy slowed down progressively in the next four quarters to a mere ½ per cent in the second quarter of 2003. In the third quarter of 2003 the growth in production rose somewhat to an annualised rate of 1 per cent. This brought the increase in real gross domestic product to only 2 per cent in the first nine months of 2003 compared with the same period in the preceding year, i.e. to a considerably lower rate than the 3½ per cent attained in 2002 as a whole.

As could be expected if world economic conditions are taken into consideration, this decline in domestic production was mainly the result of a decrease in the volume of net exports. The growth in South African exports has always been closely correlated with world demand for our goods, especially the demand for our minerals and metals. The recovery in the exchange rate of the rand also had a significant price effect on manufacturing exports to the rest of the world. At the same time it was accompanied by a rise in real imports to South Africa. Fortunately a considerable improvement in the terms of trade of the country related to a substantial increase in international commodity prices, softened the effect of a deterioration in the volume of net exports. As a consequence, the surplus on the current account of the balance of payments in 2002, changed to a deficit of approximately 1 per cent of gross domestic product in the first nine months of 2003. This relatively small deficit poses no threat for a recovery in domestic economic growth.

Growth in domestic production during 2003 continued to be supported by domestic demand. Domestic final demand increased at a rate of 4 per cent in the first nine months of 2003 compared with the same period in the preceding year. This continued high growth in domestic final demand was the result of increases in consumption as well as fixed capital formation.

The growth in real final consumption expenditure by households also remained strong throughout 2003. The sustained high growth in private consumption expenditure was underscored by a rise in real personal disposable income owing to recent salary and wage increases, a reduction in income tax rates and more recently the decrease in interest rates. To supplement the growth in their disposable income, households became more willing to incur debt. Consequently, households debt as a percentage of disposable income rose somewhat from 51 per cent in the fourth quarter of 2002 to 53 per cent in the third quarter of 2003. This level is still low compared to those of many other countries.

The strong domestic demand was also supported by growth in real final consumption expenditure by general government at an annualised rate of about 4 per cent in the first three quarters of 2003. This was mainly due to government purchases of goods and services, while real spending on salary and wages of government employees was rather restrained.

Expenditure on real gross fixed investment continued to be buoyant throughout the first nine months of 2003. Private business enterprises as well as the public sector increased their fixed capital outlays. The government and public corporations increased their capital expenditure on infrastructure expansion aimed at service delivery, while private business appeared to be making the most of conditions that favour expenditure on capital goods. Such conditions included an exchange rate conducive to importing goods, a lowering in the cost of borrowing, rising prices in international commodity markets and considerably more stability on the inflation front.

The strong domestic final demand was unable to prevent a decline in manufacturing output. Having increased robustly in the first half of 2002, real manufacturing output started to grow at a slower rate in the second half of that year and then declined in the first nine months of 2003. This was mainly a reflection of lacklustre global growth trends and the recovery in the exchange rate of the rand. Most of the subsectors of manufacturing were affected by a low demand for exports and increased imports as a greater proportion of domestic demand was met by competitively priced imports. As could be expected, this had a marked effect on employment.

4. Inflation and monetary policy

The inflation outlook improved significantly during 2003. The twelve-month CPIX inflation fell from a peak of 11,3 per cent in October 2002 to below the upper boundary of the inflation target from September 2003. In October 2003 it even receded to below the mid-point of the target range when it reached 4,4 per cent. This achievement was underpinned by the sustained maintenance of prudent monetary and fiscal policies together with the recovery in the international exchange value of the rand and a moderation in food price increases.

As the inflation outlook improved, the monetary policy stance was adjusted on four occasions in 2003. The first reduction in the repo rate was only made in June 2003, but there were already clear signs that the inflation rate was moving towards the inflation target at the March meeting of the Monetary Policy Committee. At the time of that meeting it was felt that upside risks limited any possible actions that the MPC could take. In particular, the commencement of the war in Iraq on the first day of the meeting had an important effect on the Committee's decision.

As the uncertainties about the inflation outlook dissipated and it became increasingly apparent that most factors favoured the attainment of the inflation target in the next two years, the MPC started to lower interest rates. The repo rate was cut by 150 basis points in June, by 100 basis points in August and September, and again by 150 basis points in October. All in all, a total reduction of 500 basis points in a period of only five months. This was indeed an aggressive lowering of interest rates. Nominal rates are at levels last seen in the 1980s, but the difference is that the current and expected inflation rates are significantly lower than those observed in the 1980s.

Although international and domestic economic conditions have allowed the MPC to reduce short-term interest rates in an aggressive manner, the overriding objective of the Reserve Bank remains the attainment of the inflation target. Achieving low inflation is not an end in itself. It is important because it is a prerequisite for sustainable high economic growth and employment creation. The current and more importantly the expected state of the domestic economy will always carry weight in the determination of monetary policy.

5. The exchange rate of the rand

Of all the recent economic developments, the behaviour of the external value of the rand has attracted the most attention. The exchange rate of the rand has been very volatile during the past few years. After the nominal effective exchange rate of the rand had declined by 13 per cent in 2000 and 34 per cent in 2001, it increased by 24 per cent in 2002 and by nearly 25 per cent in the first eleven months of 2003. Such volatility in exchange rates seems to be a fact of life in most economies these days. Fluctuations in the external value of currencies are unavoidable in the current international monetary system of generally floating exchange rates. Even when currencies are pegged to another currency or to a basket of currencies, they still float against other currencies and fluctuate widely at times.

Large fluctuations in the exchange rate of the rand are clearly not healthy for the economy. The uncertainty caused by these fluctuations makes investment and export planning extremely difficult. What may seem to be a profitable venture can turn out completely different with a substantial swing in the external value of the rand. The Reserve Bank would obviously prefer to have greater exchange rate stability, but as already indicated fluctuations in the exchange rate of the rand seems unavoidable.

The Bank can only create an environment that favours exchange rate stability. One of the most important recent developments in this regard has been the improvement in the net open foreign currency position of the Reserve Bank. The oversold foreign currency position of the Bank has always been perceived as a source of exchange rate weakness and instability. The Bank's objective was therefore to eliminate this oversold position, which stood at US$23,2 billion at the end of September 1998. During the past year this objective was finally achieved in May. At the end of October a positive net open foreign currency position of US$2,7 billion was recorded. Having removed this perceived vulnerability, the price discovery process in the market for foreign exchange should now display a better two-way trading pattern.

In an attempt to further improve the functioning of the South African market for foreign exchange, the Bank has shifted its focus to reducing its oversold forward book and to strengthening the official foreign exchange reserve position. Considerable success has been achieved in bringing the oversold forward book down to lower levels. The balance on the oversold forward book stood at US$2,3 billion at the end of October 2003, compared with US$6,9 billion at the end of December 2002. In the mean time, the official foreign exchange reserve position was also increased to a level of US$7,8 billion at the end of October 2003.

6. Conclusion

These improvements in the functioning of the foreign exchange market and the lower inflation rate should at least provide a basis for more stability in the value of the rand. However, the South African economy will always be affected considerably by developments in the rest of the world. Any weakness in the US dollar or any of the other major currencies will affect the exchange rate of the rand. Our focus can therefore only be to develop an environment favouring greater stability. Monetary policy will continue to focus on the objective of price stability. Fortunately the world economic outlook has recently improved considerably, which should assist in attaining higher domestic economic growth. In addition, the outlook for inflation looks good.

Thank you.