T T Mboweni: The state of the South African economy

Remarks by Mr T T Mboweni, Governor of the South African Reserve Bank, at the Annual Dinner in honour of the Ambassadors and High Commissioners to the Republic of South Africa, Pretoria, 7 December 2004.

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Your Excellency, the Dean of the Diplomatic Corps
Your Excellencies, Ambassadors and High Commissioners
Your Excellency, the Chief of State Protocol
Your Excellencies, Heads of International Organisations represented in the Republic of South Africa
Deputy Governors of the South African Reserve Bank
Senior Management of the South African Reserve Bank and their spouses/partners
Media representatives
Ladies and Gentlemen

Welcome once again to this annual dinner in honour of the Ambassadors and High Commissioners accredited to the Republic of South Africa. My colleagues and I always look forward with bated breath to this evening at the end of every year. This dinner represents for us the highlight of every year as we gather with you to break bread and discuss issues of common interest and relevance to our various countries.

2004 has indeed been a momentous year for the global economy. One of the distinguishing features of this year has been the oil price. When I joined the central bank in 1998, the north sea brent crude oil price was $9 per barrel. Since then, the oil price has shot up quite considerably. The price of north sea brent crude oil is now around $38 per barrel and indications are that it might not come down to the OPEC target levels of $22 - $28 per barrel in the near future. The futures price also indicates that the oil price will stay near the $40 per barrel level.

The behaviour of the oil prices has changed the global economic outlook in a real way. Estimates by the International Monetary Fund researchers is that if the oil price averages $37 per barrel in 2004, global growth will slow down by some ½ percentage point, inflation for the advanced countries will increase by about 0.3 percentage point and the trade balance of advanced countries will deteriorate by some 0.3 per cent of gross domestic product. The estimates for South Africa are that economic growth might decline by some 0.6 percentage point, inflation will increase by some 1.6 percentage point and the trade balance will worsen by some 1.4 per cent of gross domestic product.

Clearly there is cause for concern all-round.

At the core of these oil price developments seems to be concerns about supply constraints. These arise, in part, as a result of supply problems from Iraq, uncertainties about possible tensions between the United States and Iran, production uncertainties in Nigeria, the continuing problems experienced between the Russian government and the Yukos oil company, management and trade union tensions in Norway and the damage to production which was caused by hurricane Ivan in the Gulf of Mexico.

Although some of the developments mentioned above are significant, it would, however, seem to us that the oil market players are running ahead of themselves in terms of pricing. Time and again, the largest producer of oil in the world, the Kingdom of Saudi Arabia, has made it known that there are sufficient reserves and capacity to ensure that global supply meets demand. On many occasions, the Kingdom of Saudi Arabia has actually increased supply by no less than a million barrels per day. They have indicated that there are sufficient reserves for the next 50 years. And as stability returns in any troubled oil-producing country, supply surely should be guaranteed. It is maybe time for the market to pause and reflect on the perceived supply constraints. Certainly, the global economy expects no less from the oil market.

Despite these risks for the global economy now and in the recent past, substantial global economic growth has been recorded in 2003 and prospects for the whole of 2004 look promising. The global economy recorded an impressive 3.9% growth in 2003, with the United States, Japan, India, China and many emerging market economies making the most impressive contribution to global growth.

Growth rates in China and India remained the envy of all countries in 2003. Although the Chinese authorities attempted to slow down growth in their country, at growth rates of around 9%, this country continues to amaze.

It is forecast that global growth in 2004 is likely to be in the region of 5%, slowing down somewhat in 2005 to 4,3%. Based on these forecasts, we can safely say, without any fear of contradiction, that the world economy is still in a good state of growth.

The oil price notwithstanding, the global economy has shown itself to be resilient in the face of so many other constraints.

There remain, however, a number of challenges to be tackled if the world economy is to improve further in the medium to long term. At the most recent G20 meeting in Berlin on 20 and 21 November 2004, the challenges to global growth were summarised as follows: “the United States needed to urgently address its fiscal and current account deficits which are resulting in major negative adjustments in other parts of the world; Latin American countries needed to continue with broad based structural reforms and pursue prudent fiscal policy whilst at the same time continuing with policies to encourage investment; Argentina in particular was urged to continue strengthening its banking sector and reviewing its fiscal system; the European Union member countries were urged to continue with structural reforms, in particular reforming their labour markets, consolidating their fiscal positions and reforming their pension systems; the Russian Federation was urged to “create foundations for more broad based and sustainable growth at a high rate”; the Russian Federation was further urged to introduce “reforms of the banking sector and the judiciary systems”; South Africa was urged to focus on infrastructure investment, increased savings and skills development; Saudi Arabia was urged to diversify its economic structure, support private sector development and improve the business environment for foreign investment; South and Southeast Asia were urged to improve the climate for investment, in particular through regulatory reform; India was encouraged to “reduce the budget deficit while raising sufficient resources (ie reforming the tax system) for infrastructure and rural development”; Australia was urged to improve flexibility in workplace relations to expand employment options, improve the tax and income support systems and make progress more generally with microeconomic reforms; Japan was encouraged to continue with its reform agenda, including measures to promote further reform of the financial system, foster privatisation and address more vigorously the problem of fiscal sustainability; China was encouraged to continue deepening the reforms of the state asset management system and the state owned enterprises, to promote the development of the non-state sector of the economy, to consolidate and strengthen the position of agriculture, to carry forward the reforms of the financial system, the fiscal and taxation systems and the investment climate, to push forward the employment and income distribution system, to improve the social security net and strengthen the reforms of the administration management system and the legal system”. The G20 concluded by committing to “strengthening the above-mentioned framework for the global economy”. The G20 encouraged 'trade ministers to work together in good faith to enable the WTO negotiations to succeed as quickly as possible”.

Based on the G20 global economic reform agenda, referred to as the G20 Accord, one is encouraged to observe the serious commitment from these leading countries to ensure that the world economy continues to grow and prosper. It is indeed heart-warming that a common global agenda for growth is beginning to emerge amongst the world’s 20 largest economies outside the traditional Washington consensus.

Coming back to developments in South Africa, it is also pleasing to note that the hard work which has been put into policy formulation and planning in the past decade is beginning to bear fruit.

I know that you are more than familiar with the economic situation in South Africa and I therefore only wish to highlight some of the key features of the recent economic and financial developments.

Statistics SA has recently rebased and revised the economic growth numbers. This is an acceptable international best practice. The South African Reserve Bank endorses this endeavour. As a result of their extensive exercise, the developments mentioned below have been observed.

Firstly, the South African economy is larger than was previously thought. Previously, the level of the gross domestic product was estimated at R888 billion (2000), R983 billion (2001), R1 121 trillion (2002) and R1 209 trillion (2003). The revised figures show that the level of GDP was much higher at R922 billion (2000), R1 020 trillion (2001), R1 165 trillion (2002) and R1 251 trillion (2003). These revisions are fairly substantial! The Statistician General commented that “the level of the revised GDP at current prices is between 0.5 and 3.9 percent higher than the previous estimates for the period

1998 to 2003. The GDP for the year 2003 is 3.5% higher than previously reported". In summary, this means that the level of economic activity in South Africa is indeed very significant.

Secondly, the GDP per capita at current prices has improved significantly based on these revisions and if one makes use of the latest available 2001 population estimates. Previously, it was thought that the GDP per capita was R20,3 thousand (2000), R22,1 thousand (2001), R24,5 thousand (2002) and R26,2 thousand (2003). The revised figures mean that we are much better-off than was thought, R21,1 thousand (2000), R22,9 thousand (2001), R25,5 thousand (2002) and R27,1 thousand (2003).

Thirdly, these revisions confirm the observations which many people had made about the South African economy. It was clear to many that this economy was larger and growing much faster than the official data from Stats SA had previously suggested.

The challenge ahead is to maintain the momentum by focusing amongst others on what the G20 has urged South Africa to do. Of particular importance here will be the absolute fully dedicated focus on education and skills development in South Africa for a higher growth path.

Although employment creation is still at low levels, it is nonetheless encouraging to see that there has been a pick up in the numbers of people employed. According to the latest official data available in March 2004, total employment in South Africa was 11 984 million, which was a marked improvement from the total of 11 652 million in September 2003. The number of unemployed people remains high in South Africa despite this improvement. According to Stats SA, the total unemployed was 4 611 million in March 2004 as compared to the 4 627 million in September 2003. So a lot of work still lies ahead as far as employment creation is concerned. But it is encouraging that the number of people unemployed is coming down.

As we have indicated in the past, South Africa introduced inflation targeting in the year 2000. The inflation target was specified as the Consumer Price Index less mortgage cost, the co-called CPIX. The numeral target was for CPIX to remain on average between 6 and 3 percent. Now, there has been a little change to specify that the target must be met on a twelve-month continuous basis. We are happy here at the central bank to report to you this evening that since September 2003, we have been inside the target range. This achievement has also begun to influence inflation expectations in a positive way. The expectations of business, trade unions and households are now well within the target levels. This is important for inflation outcomes going forward.

In an inflation targeting monetary policy framework, it is important that we are committed to the inflation target and not target any other intermediate variable. So whilst variables such as the exchange rate, monetary aggregates, unit labour cost and oil prices play an important part in the inflation process, these should not become intermediate targets but must however be watched carefully and systematically by the central bank.

The exchange rate of the rand is determined by the supply and demand developments in the foreign exchange market. The central bank does not target any level of the exchange rate but takes the rate as given by the forex market. Due to the importance which attaches to the exchange rate in the inflation process, a competitively priced exchange rate is the preferred outcome for the central bank. We neither prefer a weak rand nor an overvalued exchange rate. We prefer a competitively priced exchange rate.

From time to time, exchange rates have a tendency to over- or undershoot in the market. This can be the case if, for instance, global imbalances lead to a depreciation or an appreciation in some of the more significant currencies such as the American dollar. Indeed the current level of the dollar is occasioned in the main by the large American current account deficit on their balance of payments. For as long as the rest of the world is willing to finance this deficit by buying American assets, the current account deficit is easily financed but the market seems to have become somewhat doubtful recently. We do not share the view that the American dollar will collapse. Yes, there will be some gradual adjustment as a result of the current account deficit but our hope is that these adjustments should be measured and orderly and not be disruptive to the global currency markets. Extreme volatilities in the forex markets are not helpful to all of us.

One should therefore expect that in the current period and in the near term, the rand will show some strength against the dollar. But the rand is not alone in this. Indeed the Euro, Australian dollar, Japanese Yen and many other significant currencies are showing signs of strengthening against the American dollar. This should be expected.

But our central bank is not losing focus. And indeed it should never lose focus. We are in the business of targeting inflation and not any other intermediate variable.

We have taken advantage of the current conditions in the forex market to purchase significant amounts of foreign currency in the market as part of the process of building up our foreign exchange reserves. You might recall that in 1998 we had a negative net open foreign currency position of some $23 billion. That was a difficult time for us here at the Bank. Through some carefully planned processes, we have eliminated the negative net open foreign currency position and now we have some positive $14,4 billion in our gross gold and foreign exchange reserves account. The building of reserves is seen as fundamental to the stability of the foreign exchange market. We therefore hope to see a much more stable exchange rate going forward. I know that a stable foreign exchange market is also of significant importance to the Diplomatic Corps as it brings about stability and certainty in your budgeting processes. We are glad that by eliminating the negative NOFP we could be of some assistance to you.

The competent macro-economic management, including fiscal and monetary discipline, has led to the country's improved economic outlook as well as to the enhanced sound economic fundamentals. International investors have recognised the progress achieved and have in recent years changed their sentiment towards South Africa. The positive sentiment towards the country and the high level of confidence in its future progress has also been supported by numerous ratings upgrades from major international rating agencies over the last few years. These ratings are supported by a stable and transparent macro-economic policy framework; a record of fiscal prudence resulting in moderate public debt levels; and a much improved external liquidity position after the closure of the forward book.

The credit ratings continue on an upward path. Currently Moody's is reviewing the country for a further upgrade, which could see South Africa's foreign currency rating move from the current Baa2 (lower investment grade) to Baa1 (higher investment grade). Towards the end of October 2004 Fitch revised their outlook on South Africa's BBB rating from stable to positive.

Inflows into South Africa's bond and equity markets, which were largely elusive in 2002/2003, witnessed a significant turnaround in 2004. Faster economic growth combined with a low inflation environment and interest rates at multi-decade lows has seen non-residents return to the equity market. For 2004 to date, the equity market has enjoyed inflows to the value of R25,9 billion. While on a net basis, the bond market has experienced outflows, these remain small in comparison with the outflows experienced in 2003 (-R1,7bn when compared to -R8,1bn) . In fact, the bond market registered an inflow of R3,9 billion in November alone, as yields on domestic government bonds continued to move to fresh lows during the month. These capital inflows do not only reflect lower risk perceptions justified by improved credit ratings, but clearly indicate a high level of confidence in South Africa's macro-economic future.

Positive sentiment is also reflected in the spreads of South Africa's foreign currency denominated bonds in relation to US Treasuries. The spreads on the South African sub-index over US Treasuries narrowed significantly. For the first time since its launch, this sub-index closed below the 100-basis-points level, ie at 94 basis points, on 4 November. The improvement was supported by the country's positive credit rating outlook, the performance of the rand and other sound economic fundamentals. At these levels, South Africa compares favourably with Poland, Malaysia and Thailand, whose credit ratings are at the upper level of investment grade. On 30 November, the South African sub-index narrowed further to 92 basis points over US Treasuries. The spreads of South Africa's US-dollar denominated bonds maturing in 2009 and 2012 narrowed to 102 and 72 basis points over US Treasuries respectively between 14 October and 30 November 2004. The 10-year US dollar global bond issued in May this year similarly tightened from 195 basis points over US Treasuries at its launch in May to currently around 103 basis points.

A ratings upgrade by Moody's would put South Africa on the same scale as Thailand whose ten-year US-dollar denominated bond spread is currently trading around 52 basis points over US Treasuries. This suggests that South Africa's ten-year US dollar denominated bond, which is currently at 85 basis points above US Treasuries, could rally further.

Another clear indication of South Africa's improving creditworthiness can also be seen in increasingly narrower margins paid on our international syndicated loans. Whereas in 2001 we were paying 85 basis points p.a. over LIBOR for a three-year loan, by 2003 the margin had come down to 67.5 basis points p.a., and earlier this year we were able to improve the terms further and negotiate a margin of 47.5 basis points p.a. over LIBOR.

The relations between South Africa and so many countries in the rest of the global village, evidenced by the number of embassies and high commissions stationed in South Africa, bears testimony to this confidence.

My colleagues and the senior management staff at your tables will hopefully clarify and amplify some of the remarks I have made during this evening. Meanwhile, welcome once again and thank you for accepting our invitation to this Annual Dinner in honour of Ambassadors and High Commissioners posted to the Republic of South Africa. Your friendship is not taken for granted, it is highly valued.

Thank you very much.