T T Mboweni: How exposed is the rand to the potential outflow of hot money?

Remarks by Mr T T Mboweni, Governor of the South African Reserve Bank, at The Economist's Fourth Business Roundtable with the Government of South Africa, Johannesburg, 21 November 2005.

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It is difficult to quantify the exact potential of "hot money" outflows. Undoubtely there is some of it in South Africa, similar to any other high-yielding emerging-market country with a liquid currency market.

Some rough indications of potential "hot money" are the following:

- the high turnover in the foreign exchange swaps market, with mainly non-resident clients as counterparties.
- some build-up in authorised dealers' net forward commitments against rand
- non-residents have increased their holdings of domestic bonds and equities by some R45 billion in the current year to date.

South Africa's current account deficit is financed by (predominantly) foreign portfolio investments which can be easily reversed, while foreign direct investment is generally regarded as being more stable. However, two observations can be made in this regard:

- The IMF in March 2005 published a study entitled "The composition of capital flows: Is South Africa different?" This paper argued that ZAR stability and some changes to government policies could contribute to greater FDI. The paper noted, however, the SA attracted three times more foreign portfolio investment than any emerging-market country, as a percentage of GDP. Equity flows to South Africa remained well above levels in other developing and emerging markets. The composition of capital flows to South Africa appears to be quite the opposite of other emerging markets. Importantly, it is noted that South Africa has attracted portfolio inflows <u>more consistently</u> than other countries.
- There are indications that FDI might increase (Absa/ Barclays, Vodafone) as we sustain healthy growth rates, the exchange rate becomes more stable and exchange controls are relaxed further and eventually abolished.

The rand has become more stable: ZAR volatility has declined over recent months – historical volatility down from as high as 30 per cent in the middle of 2003 to below 10 per cent in October 2005

Behaviour of importers and exporters has become more rational – Balances in CFC accounts stay fairly constant, whereas during 2001 and 2002, there tended to be build-ups in balances as exporters anticipated the ZAR to depreciate. The average holding period of export proceeds is also healthily within the 180 day limit, and remaining fairly stable.

A number of stuctural empediments that contributed to the ZAR's volatility in the past have been removed or improved. E.g. the closure of the NOFP, and the building of international reserves to USD20 billion. This has improved the fundamental value of the ZAR, and also resulted in upgrades by the international ratings agencies. These factors contribute to the ZAR becoming a longer-term investment destination rather than attracting predominantly "hot money".

"Hot money" often tends to be a reference to speculative flows, which can sometimes negatively affect a country. The best way to protect oneself from detrimental speculative flows is for South Africa to continue on its path of responsible, predictable, consistent and transparent policies.

Can the economy pick up speed with such a strong currency?

International research on the relationship between the exchange rate and growth remains inconclusive to date, as it is difficult to isolate the effect of the exchange rate from other policies and economic structures that would support or hamper growth. Typically, some sectors gain from a strong exchange rate, while others lose.

There are a number of indicators that provide some comfort that the South African economy is coping well with an exchange rate at the current levels, e.g. GDP growth of some 4,8% (quarter on quarter saar) and relatively strong manufacturing growth.

The mining sector is usually particularly negatively affected by a strong exchange rate. However, the high commodity prices are providing some cushion in this regard.

The global environment has been conducive to South African exports.

It is the view of the SARB that a stable currency is more important that a particular exchange rate, and that a particular exchange rate should not be targeted alongside an inflation target. The role of the SARB is to contribute to an environment of financial stability in the interest of sustainable economic growth over the long term, rather than providing short-term growth incentives that, from past experience, can severely damage sentiment and economic growth over the long term.

Outlook for key indicators

The **inflation** outlook has deteriorated moderately, with CPIX now seen at the upper end of the 3 – 6 per cent range in the first quarter of 2006. Nonetheless, inflation should remain within target range over the forecast period. This is, among others, dependent on the future path of oil prices, and developments in the exchange rate of the rand and food prices.

Inflation expectations, as can be expected, have deteriorated moderately, but on the whole still point to CPIX remaining within target over the next three years. The Bank needs to guard against inflation expectations worsening further and becoming entrenched.

Economic growth should remain robust, despite the fact that oil prices will most likely have a dampening effect on growth. The manufacturing sector appears to have weathered a relatively strong rand quite well, while global economic conditions are such that export growth should be maintained at a healthy pace.

Both **consumer and business confidence** should remain high, with the factors supporting consumer confidence in 2005 still effective in 2006 – healthy disposable income, structural changes in the economy, and still low nominal interest rates.

Money supply and credit extension should witness a mild moderation, alongside growth in the housing market. We have noted signs of cooling off already. Expectations of interest rate increases are likely to dampen credit demand (mortgage financing) somewhat. However, certain country-specific factors are likely to support still high and positive rates of growth, namely, the participation of non-resident buyers in the local market, the emergence of a new middle class, strong consumer demand, and a general catching up in the local housing market with international developments.

International developments point to a moderation but still healthy economic growth rates, and while the inflation outlook internationally has deteriorated, the overall picture remains benign. This should support both economic growth locally and limit inflationary pressures in the local economy.

The **balance of payments** may witness a mild deterioration, however, capital inflows, both portfolio and foreign direct investment, should be sufficient to finance this.

Fiscal policy remains supportive of a non-inflationary expansion in economic growth.

The Bank will continue to build its **foreign exchange reserves**, and purchase foreign currency at opportune times in a manner that does not destabilise the financial markets.