T T Mboweni: A financial and economic review of the year

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 accredited to the Republic of South Africa, Pretoria, 24 November 2005.

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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 officers of the South African National Defence Force
Senior Management of the South African Reserve Bank and their spouses/partners
Editors and other media representatives
Ladies and Gentlemen
Dear Friends

Welcome once again to this annual dinner in honour of the Ambassadors and High Commissioners accredited to the Republic of South Africa. It has been yet another challenging year for South Africa on many fronts, and although you are no doubt familiar with many of these issues, I wish to highlight briefly the most noteworthy international and domestic financial and economic developments that have transpired since the Bank was honoured by your presence last year.

Economic and financial conditions in the international economy have remained generally benign in recent months although there have been a number of challenges. Led primarily by China, India and the United States, the world economy continued to grow at a solid rate although growth projections for 2005 in most countries have been revised downward slightly – with the important exceptions of key Asian economies. The major global imbalances, such as the difference between the US and Asian propensities to save, show no significant signs of reversal. However, underlying inflationary pressures in most countries generally have remained muted, resulting in little transmission of price pressures to the South African economy.

Real gross domestic product growth in the US economy remained strong during the first three quarters of 2005. However, real economic growth in the euro area, South Africa's largest trading partner, was comparatively disappointing, while growth in most developing countries exceeded expectations. The relatively strong world economy, favourable prices of commodity exports and improved policies contributed to an acceleration in growth on the African continent. Non-oil commodity prices have continued to rise during 2005, with strong demand for metals from the US and China -where the manufacturing and construction sectors are recording robust growth - driving prices higher. Prices of iron ore, copper and uranium in particular have risen significantly in recent months. The gold price in dollar terms has also shown a significant increase over the same period as a result of fears of rising global inflation; concerns about geopolitical security; mounting speculation regarding a possible reversal in central bank gold sales; declining mining supply; and strong fabrication demand for gold.

Global real gross domestic product grew by about 5 per cent in 2004 and is projected to increase by 4½ per cent in 2005. Growth in some of the developed economies slowed in the second quarter of 2005 while emerging-market economies continued to record robust growth. However, to date the impact on global growth of higher oil prices has been moderate, reflecting in part the fact that higher oil prices have been largely the result of strong global demand. Even though core inflation rates have remained benign, overall inflation rates in most countries have already increased somewhat in response to the sharp rise in oil prices. The world economic outlook therefore remains somewhat clouded by large global imbalances and rising crude oil prices.

Crude oil prices have risen significantly over the past year and have on occasion touched US$70 per barrel. This can mainly be related to robust demand for oil emanating from particularly the economies of China and the US, notable supply side shocks emanating from the hurricane season, and continued geopolitical concerns. The oil price is likely to continue exhibiting considerable volatility and is expected to remain at relatively high levels in the near term mainly due to strong demand and supply-side tightness. The rise in global energy prices will continue to exert downward pressure on the purchasing power of households and international inflation is likely to continue edging upwards in the next few months. World inflation is projected to increase to 3,9 per cent in 2005 from 3,7 per cent in 2004. Fortunately, relatively well-anchored inflationary expectations and declining oil intensity in production have served to soften the blow to the global economy so far. Single-digit inflation – and low single-digits , at that – is the norm for the overwhelming majority of countries represented here tonight.

If the oil price continues to escalate, second-round effects of price rises could become more prominent, thus leading to a further acceleration in global inflation. However, the short- to medium term global inflation outlook remains positive, particularly in view of the fact that inflationary expectations remain somewhat well anchored and output gaps in most countries are not subject to undue pressure. Notwithstanding these slightly adverse developments, global economic expansion is expected to remain broadly on track against the background of continued supportive global financial conditions.

Turning to developments in South Africa, it is pleasing to note that the record upswing in economic activity continues apace. What is particularly gratifying is that the rapid expansion in economic activity in the second quarter of this year marked the twenty-third consecutive quarter of uninterrupted growth since the economy began the current upswing in 1999. This is the longest upswing in the recorded economic history of our country, and is a truly remarkable achievement given the domestic, regional and international challenges that have confronted South Africa during the course of the upswing.

The consolidation of inflation at low levels has enhanced macroeconomic stability and contributed to the strong growth in the South African economy and the record upswing is testimony to an increasingly stable and transparent macro-economic policy framework that has been developed meticulously over the past decade. This has resulted in increasing levels of domestic and international investor confidence in South Africa that augurs well for the domestic economic growth outlook. Allow me to highlight a number of the most important domestic developments since I had the privilege of addressing you last year.

A significant milestone was reached at the end of last year when the rand was included in the Continuous Linked Settlement (CLS) system – currently being one of only 15 currencies settling through CLS. It is now possible to make a payment here in South Africa and have it immediately transferred to a beneficiary abroad in one of the other 14 currencies' areas without the risks attached to delay in settlement.

The sustained capital inflows into the country have allowed for a continued build-up of the official foreign reserves and have contributed to increased exchange rate stability. The South African Reserve Bank's gross reserves now stand at almost US$20 billion - more than US$5 billion higher than a year ago. This was despite a fairly large deficit on the current account of the balance of payments. As you are aware, South Africa currently imports more than it exports. This is to be expected, given the growing economy which requires more capital goods – often imports – and which allows for more consumption, some of which also involves purchases of imported goods. However, the financial-account inflows have exceeded the current account shortfall.

Your Excellencies would know only too well that the exchange rate of the rand has depreciated somewhat, on balance, since the end of last year. Against the US dollar, for instance, the rand depreciated notably: a US dollar cost less than R5,70 towards the end of last year, but currently would put you back about R6,60. Against a basket of currencies, the rand has depreciated by roughly 6 per cent since the end of last year. The relatively moderate amplitude of the exchange rate movements of the rand – against a basket of currencies, at least – should be welcomed.

Prices in the financial and real-estate markets have reached new record highs. The financial and real-estate markets remained buoyant, but with the changed outlook for mortgage interest cost, the rate of increase in real estate prices, which at times exceeded 35 per cent on a year-on-year basis, tapered off over the course of 2005. Its most recent reading is still a quite strong 16 per cent. So embassy property must have turned out to be well-performing investments indeed.

The price stability objective in South Africa continues to be strongly supported by government's management of its financial affairs with the National Government Budget for fiscal 2005/06 again formulated within a framework of fiscal discipline but with more emphasis on infrastructure development and a budget deficit for 2005/06 now projected to amount to only 1,0 per cent of GDP, compared to the 3,1 per cent of GDP projected in February.

The government debt consolidation process has allowed the cost of borrowing to decline markedly. Even though debt issuance has increased since 2003/04, sound debt management has been such that new issuance is spread across the maturity spectrum of the yield curve. The latter normalised somewhat in recent months owing, among other things, to the fact that the National Treasury increased supply at the longer end of the curve.

With the cost of borrowing falling as dramatically as it has, the bond market has become a more appealing corporate finance tool and, as such, corporate bond and commercial paper listings have become more popular. The corporate bond market has increased considerably in size – expanding from just under R40 billion in 2002 to over R130 billion today – an increase of over 200 per cent!

The improvement in South Africa's long-term foreign currency debt rating from BB (high risk, speculative grade credit) in 1994 to BBB+ in 2005 (investment grade rating), made South Africa's debt much more attractive to the international investing community. The most recent upgrades by Fitch and Standard and Poor's contributed towards tighter spreads on South African debt. The yield spreads on South African foreign-currency denominated bonds continue to remain substantially lower than those of emerging markets in general (the Emerging Market Bond Index), indicating that investors share the confidence expressed by international rating agencies and regard South Africa in an increasingly positive light in comparison to competitors.

Non-residents have been very active participants in the domestic bond and equity markets this year. Non-resident participation in trading on the Bond Exchange, measured as the sum of their purchases and sales as a percentage of total purchases and sales of bonds, increased markedly from a level of about 9 per cent in early 2004 to as high as 18,9 per cent in early 2005. Furthermore, non-resident participation in share trading on the JSE averaged approximately 20 per cent in both 2004 and 2005 thus far.

The Eurorand bond market witnessed a flurry of activity this year, with a total net issuance size for 2005 of close to R6 billion, the highest net issuance since 1999. The issuance of rand-denominated bonds by non-resident borrowers in the Japanese Uridashi market also continued to grow during 2005. Rand-denominated bonds were first issued in that market in July 2004 and total issues for that year amounted to R2,5 billion, while issuance amounted to R7,5 billion in 2005. The demand for rand-denominated bonds issued by highly rated non-resident institutions contributed positively to the value of both the rand and domestic bonds.

We also witnessed some secondary listings of foreign companies on the JSE Limited and the first listing of a non-resident bank on the Bond Exchange, again displaying confidence in South Africa (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).

The South African banking sector benefited greatly from the improved macroeconomic conditions – profitability, efficiency and the asset quality of banks improved despite continued strong growth in the total loan book. An important structural change also occurred in South Africa's banking sector after an international bank obtained a controlling share of a major local bank by means of the largest single foreign direct investment into South Africa to date – together with other significant foreign direct investment announcements which are also indicative of an increasingly positive investment outlook for South Africa.

Broadening access to financial services and targeted investment remain high priorities on the agenda for South Africa and our financial sector, and the Bank continued to monitor and support new initiatives. In terms of a Memorandum of Understanding between the banking sector and the Department of Housing, the banking sector will advance R42 billion in low-income housing finance by 2008.

The Bank continued to make a significant contribution to economic co-operation in Africa by for expample liaising closely with the Association of African Central Banks regarding the implementation of the African Monetary Cooperation Programme and participating in an ongoing study outlining the costs and benefits of the creation of a common central bank for Lesotho, Namibia, Swaziland and South Africa (the decisions in this regard will be taken by the political leaders of these countries).

In February 2005 the Bank hosted a Seminar with the European Central Bank (ECB), attended by Southern African Development Community (SADC) Central Banks in which views on the road towards a Single Central Bank for SADC were discussed against the background of the ECB experience. The MoU on the Harmonisation of Legal and Operational frameworks of SADC Central Banks was finally approved by Ministers for Finance at their meeting held on 5 August 2005 after extensive consultations. At their September 2005 meeting, the Committee of Central Bank Governors (CCBG) in

SADC signed Memoranda of Understating (MoUs) on Exchange Control, Information and Communications Technology and Payment, Clearing and Settlement Systems.

In May 2005, the Bank was privileged to host the first Financial Stability Forum (FSF) African Regional Meeting. Participants included ministers of finance, governors of central banks and senior officials from finance ministries, central banks and regulatory authorities from various countries in Africa as well as members of the FSF.

In June 2005 the Bank participated in workshops on a SADC cross-border settlement model. The Bank, in conjunction with other central banks in the SADC region, is investigating options to facilitate the settlement of cross-border payments within the region.

The Bank contributed significantly to the development and deployment of the Bank Supervision Application solution, a computerised system which was developed on behalf of SADC and some East African countries. This application was deployed in all eleven participating countries and is utilised to supervise commercial banks and other financial institutions.

International involvement obviously extends beyond Africa and the Bank continued participating and collaborating in the activities of a number of international organisations, central banks and universities. For example, a highly successful G-20 seminar on economic growth, co-hosted by the Bank along with the People's Bank of China and the Banco de México, was held in Pretoria in August 2005, and the findings were discussed at the meeting of deputy finance ministers and deputy central bank governors in China in September and ultimately at the meeting of finance ministers and governors in October at the Grand Epoch City, Xianghe, Hebei Province, China.

In August I mentioned in my address to shareholders of the Bank that closer economic co-operation in the SADC region and the African continent will increasingly become a key strategic focus area in the years ahead. The Bank has for example during the course of the year once again rendered technical assistance to various other central banks in the region. The pursuit of price stability will nevertheless remain the primary objective of the Bank. The consolidation of inflation at lower levels and with lower variability is by far the most important contribution the Bank can make to the economic development of South Africa and by implication that of the subcontinent.

Of particular importance therefore from a monetary policy perspective is that CPIX-inflation remains within the target range of 3 to 6 per cent. Considerable success has been achieved in pursuit of major policy objectives and the South African Reserve Bank remains committed to ensuring that the hard-won gains in the fight against inflation are not forfeited. Inflation has extended its stay within the 3-to-6-per-cent target range to 26 months – more recently amid a strongly growing domestic economy and robust domestic demand. The inflation outlook has deteriorated moderately over the past few months, mainly as a result of developments in international crude oil prices. Although domestic demand and output remain buoyant and point to some additional upward pressure on inflation, there is still little evidence of demand pressures or second-round effects of oil price increases impacting on inflation. Oil prices, domestic demand and output developments nevertheless pose significant risks to the inflation outlook and monetary policy will have to remain vigilant.

Finally, you would have noticed during the course of the year that increasing prominence is being given by government to investigating all the feasible ways of achieving stronger economic growth. Whereas growth in real gross domestic product amounted to 3,7 per cent in 2004, the October *Medium Term Budget Policy Statement* provided for real growth of 4,4 per cent in 2005 and approximately the same rate of growth in 2006. Despite some progress made in recent years, continued high levels of unemployment necessitate even more ambitious steps to strengthen South Africa's growth potential in order to achieve sustainable higher economic growth. The South African Reserve Bank is committed to doing its part by containing inflation, thereby providing a launching pad for enhanced growth, development and employment creation. But as I have mentioned on various occasions during the course of this year, this is not a sufficient condition for stronger growth. Enhanced infrastructural development, the implementation of education and skills development programmes which deliver the skills necessary for a modern economy, and careful land and agriculture reform, greater infusion of technology in the economy, and labour market reforms are some of the most important prerequisites for boosting economic performance and employment creation. The macroeconomic policy setting is appropriate. Going forward, structural reforms will be key to unlocking the economic growth and development potential of South Africa. The authorities are on the correct path. All of these reforms need to be nurtured carefully as it takes a while before they bear fruit. However, it is crucial that they be supported throughout by a stable and transparent macroeconomic policy framework.

As always, the senior staff of the Bank present at your tables will be available if required to clarify any of the remarks I have made during this evening. Meanwhile, a hearty welcome once again and thank you for accepting our invitation to this Annual Dinner in honour of Ambassadors and High Commissioners accredited to the Republic of South Africa. Your attendance is much appreciated.

Thank you.