T T Mboweni: The commodity price boom and the South African economy

Address by Mr T T Mboweni, Governor of the South African Reserve Bank, at the Regional Business Achievers Awards Dinner of the Businesswomen's Association, Pretoria, 27 June 2007.

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Honoured guests
Ladies and gentlemen

1. Introduction

Thank you for your invitation to speak at this business achievers awards ceremony. For too long the world of business has been a domain for men only, but in recent years more and more women have been making their mark in this arena. The Businesswomen's Association has been instrumental in promoting and encouraging women who have entered the business world. The important role that women played in the liberation of our country is without question. Women have also played an important role in various fields which have contributed to the overall development of the country. It is now time for women to be at forefront of the business sector. Women in business are a scarce resource and your efforts deserve support.

The economic environment in South Africa has been extremely positive in recent times, with growth averaging around five per cent for the past three years. An important contributing factor to this favourable environment has been the behaviour of commodity prices. As a commodity producer, we should be pleased when commodity prices are performing well. However, as we know from past experience, commodity price booms can be a mixed blessing. Too often in our history we have ignored the fact that commodity prices move in cycles. There had been a tendency to regard price booms as being permanent, only for things to end in tears when the cycle ended. The current boom has persisted for longer than many had predicted, leading to suggestions that we are now in a commodity super-cycle. At the same time, commodities have become a new asset class on their own. In my comments this evening I will highlight some of the recent developments in commodity prices and some of the challenges posed for the economy in general and monetary policy in particular.

2. Commodities and the South African economy

As you are aware, commodities have played a central role in South Africa's economic development. The mining industry, largely supported by gold, diamonds, coal and the platinum group of metals, has for more than a century contributed significantly to the national economy. It has provided the impetus for the development of physical infrastructure, as well as the establishment of the country's secondary industries.

South Africa is a leading supplier of a range of minerals and mineral products. According to the Chamber of Mines, in 2005, approximately 55 different minerals were produced from 1 113 mines and quarries, of which 45 mines produced gold, 29 produced platinum-group minerals, 64 produced coal and 202 produced diamonds. Mining, therefore, remains a key foundation of the South African economy. In 2005 mining made a direct and indirect contribution of approximately 15 per cent to GDP, accounted for around 50 per cent of merchandise exports (including primary and beneficiated mineral exports), 12 per cent of fixed investment, 30 per cent of the market value of the JSE limited and 20 per cent of formal-sector employment.

However, it is important to note that an abundance of resources has not always implied a prosperous economy. This is particularly true for many resource-rich African countries, which until recently have not benefited from their resource endowments. Natural resources are also not a prerequisite for growth. Countries such as Japan and Switzerland with few natural resources have at times outperformed countries with a wealth of resource endowments. In fact, having natural resources is sometimes regarded as a curse. As far back as the 1950s, Prebisch and Singer postulated the secular decline of terms of trade of commodity-producing countries. The essence of their argument was that commodity prices had a tendency to decline over the long term. This, until recently, has been largely borne out by empirical evidence.

In the last 140 years there have been 18 commodity cycles, with slumps being more persistent than booms. In some instances in sub-Saharan Africa, commodity price slumps have lasted over 30 years. However, since 2001, as commodity prices have boomed, we have witnessed impressive economic growth in many of the resource-rich African countries. Notwithstanding the structural shift from a commodity-based country to a more services-oriented one, South Africa has also experienced a concomitant increase in growth over this period.

3. Commodity price movements over the last five years

During 2001, the overall commodity index as measured by the International Monetary Fund began to increase steadily. This increase has continued well into 2007, particularly in the case of energy and metals. Not only have the increases been more persistent, giving rise to the super-cycle hypothesis, but the surge has been larger than in previous cycles. Increases have also differed significantly across commodities. For example the price of North Sea Brent crude oil increased from around $19 per barrel in 2002 to around $72 per barrel in June 2007, having peaked at almost US$80 per barrel in August last year. Metals have also shown a strong increase with gold and platinum prices having increased by approximately 120 per cent over the same period.

Agricultural prices, by contrast, have displayed more volatility and less growth when compared to energy and metals. Between 2001 and 2006, the IMF commodity food price index increased by 36 per cent. More narrowly, and perhaps more relevant to South Africa, the cereals price index increased by 48 per cent over the same period. In 2006 alone, the IMF maize and wheat price indices increased by 24 per cent and 26 per cent respectively. Food price inflation is becoming a world-wide concern and South Africa has not been spared. Spot prices of yellow and white maize have increased from levels of around R500 per ton in 2004 to current levels of around R1 800 per ton driven in part by international price developments. In October and November last year, meat prices increased at year-on-year rates of almost 20 per cent, and currently overall food inflation is in excess of 8 per cent per annum.

4. What has driven the recent price increases?

It used to be the case that the growth cycle in the United States determined the commodity cycle. More recently, with the emergence of the Asian economies and China in particular, the dominant influence of the US economy on the commodity cycle has waned. Most commentators attribute the recent escalation of commodity prices to the increase in demand for raw materials by China in the wake of this country’s ongoing economic growth and industrialisation. Two factors are frequently mentioned as part of the explanation of China’s impact on global commodity prices. Firstly, China’s large population of over 1,3 billion and the associated large pool of unskilled labour have contributed to increased competitiveness and has led to China being the leading manufacturing production centre of the world. This has in turn kept the demand for commodity inputs in manufacturing high. Secondly, China’s industrialisation comes at a time of ongoing globalisation, which has contributed to overall demand for commodities globally.

China’s contribution to global growth in the consumption of base metals in recent years has been considerable. According to the IMF World Economic Outlook, between 2002-2005, China’s contribution to world consumption growth in aluminium, copper and steel was around 50 per cent. Furthermore, China contributed in excess of 80 per cent to increased world demand for nickel and tin. More significantly, over the same period, China accounted for all the consumption growth in lead and zinc, and for 30 per cent of world consumption growth in oil. Due to its rapid growth and rising share in the world economy, China is expected to retain its critical role in driving commodity price movements.

The recent increase in food prices has been the result of a number of factors including a weaker US dollar, the impact of higher energy and fertiliser prices, crop-specific supply shortfalls and droughts, and low inventory levels. Some analysts suggest that higher global real incomes have also contributed to the upward pressure on food prices. An increasingly important driver of agricultural prices comes from the strong demand for bio-fuels, which has seen the diversion of agricultural output to energy production. Although a number of countries have made significant strides in bio-fuels production, the United States and Brazil together account for more than 70 per cent of worldwide production of ethanol.

5. The commodity price boom and the markets

In recent years, investor interest in commodities has increased in line with the rise in commodity prices and increased global liquidity. Trade in commodity indices, which total approximately US$100 billion has increased by a factor of 20 in the past decade. This is still relatively small compared to other asset classes but there has been a proliferation and diversification of the investor base including hedge funds and asset managers who have seen commodities as a means to diversify portfolio risk and take advantage of the high yields that have been achieved. Significantly, investors are increasingly viewing commodities as a long-term investment. The financialisation of commodities has also been boosted by developments in financial engineering, with strong growth underlying contracts and investment strategies. Expectations of continued and sustained growth in Asia, particularly in India and China, have served to fuel the increased demand for commodity asset classes.

A deeper and diversified market can bring benefits in terms of market efficiency. For example the fact that it is easier to hedge future production reduces the risk of new productive investment which may otherwise take some time to come on stream. A related issue concerns the role of speculators who are regarded by some as being responsible for price volatility in the market. Recent evidence, however, suggests that this may not necessarily be the case. A recent study conducted by the Chicago Futures Trading Commission showed that speculative traders were not leading but rather responding to market developments. This suggests that speculators have tended rather to stabilise the market.

Developments in the financialisation of commodity markets may, however, raise several financial stability questions for central banks and financial sector regulators. In particular, it is not certain whether regulators have enough information about the exposures of financial institutions to the prices of their export commodity or about how firms' foreign exchange exposure could compound their commodity exposures. Moreover, a rise in commodity price volatility could make domestic financial assets more volatile. An additional challenge for central banks stems from the credit exposure to the primary production sectors of the banking system and pension funds which have significantly increased their exposure to commodity assets. Furthermore, central banks should always be alert to sudden declines in commodity prices that may bring about deflationary pressures and financial instability in the domestic economy.

6. Economic policy challenges

Despite the positive impacts of higher commodity prices on the economy, they also create various problems and challenges for economic management. For commodity-exporting countries, commodity price booms bring with them the concern about the possibility of Dutch Disease, which arises when a booming primary sector causes the real exchange rate to appreciate, and this in turn puts pressure on the manufacturing and other tradable sectors of the economy. The concern is even greater when the cycle turns and the loss of markets by the manufacturing sector is not easily reversible.

From a fiscal policy perspective, the challenge that arises relates to the management of windfall revenues. To the extent that tax revenues are boosted by the commodity boom, there may be a need to smooth expenditure and not treat the revenue increase as permanent. A number of primary-commodity exporters, for example Chile and Norway, have created national wealth funds to ensure that expenditure can be maintained when the commodity cycle declines and tax revenues fall.

Monetary policy would be concerned with the possible impact of commodity price increases on inflation. Ironically, the strong non-oil commodity price increases have not translated into generalised inflation. In fact the commodity boom has coincided with a long period of low global inflation. Part of the reason may lie again with China and globalisation. High rates of productivity growth in China have allowed for the production of a wide range of goods at low prices despite the increased costs of inputs. In a highly competitive globalised world market and credible monetary policies, product price increases have remained low or prices have even fallen in some instances.

Oil and food prices, however, appear to be posing more of a threat to the global inflation outlook than other commodities. Nevertheless, contrary to initial fears, the impact of rising oil prices has had less of an impact on inflation and output than in previous episodes of oil price increases. This may be because of a general decline in oil intensity in many countries and more credible monetary policy frameworks. However, oil and food prices have been the driving forces of recent inflation developments in South Africa and pose the major upside risks to inflation both here and abroad.

Monetary responses to terms-of-trade shocks such as oil price increases are not straightforward and depend in part on the magnitude and duration of these shocks. In essence, the issue boils down to distinguishing between permanent and transitory changes in these prices, and how the first- and second-round effects are likely to influence future inflation outcomes. In general, central banks are not likely to change monetary policy in response to commodity price fluctuations. Monetary policy should address the risks emanating from possible second-round effects, i.e. adjustments in expectations triggered by movements in commodity prices which may exert an impact on the inflation process.

7. Conclusion

Not surprisingly, in our uncertain world, there are conflicting views on the outlook for commodity prices. Some believe that commodity prices will fall back to their long-term declining trend. Others however, foresee a sustained boom, or at worst a levelling off at higher levels, given the ongoing industrialisation in China and other emerging-market countries.

Whatever the future course of commodity prices, there is little doubt that it will have an impact on our economy. In essence, the policy responses will depend on the macroeconomic impact of the price movements. In this regard, the effect of commodity price movements on *inter alia* the trade balance, aggregate demand, exchange rate and fiscal developments are of paramount importance. From a monetary policy perspective, our key concern is the possible impact on inflation. Food and oil prices are likely to remain an upside risk to the inflation outlook in South Africa. Monetary policy has to be sensitive to the impact of these developments on inflation expectations and we will act appropriately to prevent the emergence of more generalised inflation. The South African Reserve Bank remains committed to its primary mandate of ensuring price stability, that is the maintenance of CPIX inflation between the target range of 3 to 6 per cent.

Finally, commodities will retain a central role in the South African economy in the future. A challenge facing our country, and one that is of particular relevance to this audience, is to ensure that women also play their rightful role in this area of economic activity. To this end the recognition of the achievements of women plays a significant role in fostering their interest in all sectors of the domestic economy.

Thank you.