T T Mboweni: An annus horribilis?

Address 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, 27 November 2008.

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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
Financial Editors and other media representatives
Esteemed Ladies and Gentlemen

This has been an eventful year. Some might even say it was an Annus Horribilis! The impact of the US subprime crisis, which became evident in August 2007, deepened and spread since then. At the time there was much speculation as to whether or not this crisis was going to remain confined within the financial sector, or spill over into the real sector. Initially, many analysts thought that the crisis would be relatively contained and there was also a view that there would be limited if any impact on the emerging market economies, the so-called decoupling hypothesis. Here again, the initial dominant view was that decoupling would occur and as such emerging or developing economies would emerge relatively unscathed. This view was predicated on the fact that China and India have emerged as new sources of global economic growth. Nothing could have been further from the truth. Maybe we should have thought this out better.

Whatever views existed on these decoupling hypotheses has been proven to be horribly wrong. The financial market instability has spilled over into the real economy, and the emerging market economies have not been spared. In fact, it is also probably true to say that many emerging markets are more vulnerable as they are less able to ameliorate the negative consequences of the current crisis. The previously optimistic forecasts for global economic growth have been revised downwards in the most dramatic fashion. More and more developed economies are forecasting imminent and prolonged recessions, with downward growth revisions almost on a weekly basis. These include the UK, the forecasts of the Euro area, Japan and the US economies to name but a few. These are significant trading partners of South Africa. These countries account for more than two thirds of our manufactured exports. Even the previously fastest growing emerging market economies in Asia are expected to experience some significant moderation in economic growth. In the past days, for example, the World Bank has downgraded its forecast for the economic growth rate in China for 2009 to 7,5 per cent, compared to the current economic growth rate of around 9,4 per cent.

With regards to the financial sector crisis, South Africa appears to have reasonably weathered the storm, as our financial sector remains broadly robust and stable. The South African Reserve Bank has not been compelled to make any special liquidity provision, and the domestic interbank market remains fully functional.

This does not mean that we have been spared the full impact of the fall-out from the slowing global economy. Apart from the direct consequences on our equity market s and the rand exchange rate, we have also witnessed a dramatic decline in commodity prices. It is almost hard to believe that as recently as July this year, the price of North Sea Brent crude oil had

reached a level of almost US$150 per barrel, whereas today it is trading at approximately US$50 a barrel, a level last seen in early 2005. The lower fuel costs and significantly lower volumes of world trade have resulted in a major decline of the Baltic Dry Index (an indicator of economic trends which tracks the cost of shipping goods such as coal, iron ore and grain). The index recorded a high of 11,793 points in May this year, but declined to 815 points last week.

While these developments are good news for oil-importing countries such as South Africa, particularly in the developing world, it should not be forgotten that the decline in the price of oil is part of a general decline in commodity prices. South Africa, as a commodity exporter is experiencing the negative consequences of these developments. The price of platinum, one of our main export commodities, reached a level in excess of US$2,250 per ounce in early March 2008, but has since declined to the current levels of around US$840 per ounce. Platinum, which is used in the production of catalytic converters in motor vehicles, is highly sensitive to the fortunes of the global automobile industry whose fortunes have changed significantly due to the slowdown. Domestic steel prices have declined by 25 per cent in the past weeks, and at the same time a major South African steel company announced a one third reduction in steel production in South Africa. While the gold price has also moderated somewhat, the extent of the decline has so far been relatively limited.

The decline in commodity prices has not been confined to industrial commodities. Global food prices, which along with oil prices were responsible for part of the inflation pressures experienced in the recent period, have also declined in the past few months. Both the Economist Food Price Index and the IMF Food Price Index have declined by about 30 per cent since July of this year.

The unfavourable global economic growth and commodity price developments suggest that while South Africa has managed to escape any untoward impact on its banking system, the real economy will not be immune to global developments. The South African economy has experienced positive economic growth since 1999, and growth in excess of 5 per cent per annum was recorded in the four years from 2004 to 2007. However, in 2009 the economy showed signs of slowing down. The year started off in not such a good way, when capacity constraints in electricity provision resulted in the period of load-shedding and electricity supply reductions to the major mining and manufacturing companies. This culminated in a revised annualised economic growth rate of 1,6 per cent in the first quarter of the year. The second quarter saw a rebound to a revised 5,1 per cent, but this was off the low base of the previous quarter. Third quarter annualised GDP growth measured 0,2 per cent, and reflected significant contractions in mining, manufacturing, and wholesale and retail trade. Agriculture and construction on the other han d remained buoyant. The South African Reserve Bank's leading indicator of economic activity has continued its downward trend, and business and consumer confidence indicators also show that the outlook is not viewed as being particularly favourable. Despite an inevitable slowdown in GDP growth, we do not expect a recession in South Africa at this stage.

During the past two years or so, there has been a rebalancing of the sources of economic growth from consumption to investment. The past few years has seen a significant increase in gross domestic fixed investment, from 15 per cent of GDP in 2002 to over 22 per cent of GDP in the second quarter of 2008. This has been a major achievement. The challenge will be to maintain investment at these levels in a world of heightened uncertainty. Part of this impetus has come from the strong infrastructural push from the public sector with respect to transport, telecommunications and electricity infrastructure to name a few. These projects will continue, but no doubt there will be challenges with respect to funding, in terms of both the availability and the cost, given the difficult global financial market conditions we are going through. Private sector investment has played its part as well over the past few years, and the big question that will confront us will be whether or not private sector investment will be able to stay the course during the coming months. We certainly hope so.

The higher economic growth rate experienced over the past few years had resulted in some improvements in the employment picture in South African society. According to the official statistics as published by Statistics South Africa, employment growth has averaged almost 3 per cent in 2006 and 2007, and measured 3,9 per cent in the first quarter of 2008. The unemployment rate declined to 23,2 per cent in September 2008, down from over 30 per cent in 2002. While this unemployment rate is still too high, the direction has been pleasing.

Financial stability considerations have probably increased over the past year. Monetary policy remains focused on achieving price stability whilst taking full cognisance of the changed global situation. Inflation in South Africa has exceeded the upper limit of the inflation target range since April 2007. In response to this, the monetary policy stance has been tightened, and between June 2006 and June 2008 the repurchase rate was increased by a cumulative 500 basis points. The most recent measure, published yesterday, showed that CPIX inflation declined to 12,4 per cent in October compared to the recent peak of 13,6 per cent seen in August. We are hopeful that this is the start of a consistent downward trend. Currently our forecasts indicate that we should be back in the target range by the second quarter of 2010.

The inflation outlook has been improved to some extent by a number of variables that previously were seen as upside risk factors. As mentioned above, the international oil price has declined significantly and global food price inflation appears to be moderating although is yet to feed through to domestic consumer prices. Domestic demand pressures have also subsided as household consumption expenditure has responded to the less accommodative stance of monetary policy.

Consumption expenditure has also been influenced by negative wealth effects, as housing and equity markets have weakened. Since the beginning of the year, equity prices on the JSE Limited have declined by 30 per cent, house prices have been flat or negative, and personal disposable incomes have also declined. The lower economic growth rate has meant that supply side cost pressures may also be subsiding.

Unfortunately, while there have been improvements on these fronts, we have to contend with some upside risks factors to the inflation outlook. Inflation expectations are an important driver of inflation, and we have seen a successive deterioration of these over the past year in particular. These expectations may feed through to further inflationary pressures. Our hope is that inflation expectations will respond quickly to the expected reversal in the inflation trend. Despite the deterioration however, there is still an expectation that inflation will decline significantly over the next two years.

A major risk factor is the exchange rate market which has also been buffeted by global developments. The increased risk aversion in international financial markets has resulted in a reversal of capital flows to emerging market economies in particular. Investors, fund managers and hedge funds are liquidating their positions in emerging markets and moving them to so-called safe havens. Some even call this a flight to quality. This is somewhat ironical, given that capital is moving back to the source of the problems. During the year there has been a significant realignment of exchange rates: the dollar has appreciated against most currencies apart from the yen; sterling has depreciated significantly and most emerging market currencies have also depreciated. Since the end of last year for example, sterling has depreciated by around 23 per cent against the US dollar; the Australian dollar by about 26 per cent; the Brazilian real by 19 per cent; and the Turkish lira by 26 per cent. At the same time the rand has depreciated by about 31 per cent against the dollar and about 24 per cent on a trade-weighted basis. These are significant moves which clearly do not only reflect the underlying fundamentals of these economies.

Part of the reason for the poor performance of the rand is related to the decline in commodity prices. Other factors include simple risk aversion, and the concern about the current account deficit on the balance of payments, which to date has been adequately financed through capital inflows. In recent weeks, following the latest round of financial market turbulence,

particularly after the demise of Lehman Brothers, there have been significant sales of bonds and equities by non-residents.

The ZAR and the domestic bond and equity markets were not the only casualties following the failed attempt by Barclays to acquire Lehman, subsequently resulting in the latter filing for bankruptcy on 15 September 2008. Emerging markets in general came under heavy selling pressure as risk aversion escalated.

On 15 September, Romanian shares fell by more than 4 per cent to their lowest levels in over three years while Czech and Hungarian stocks dropped to their lowest levels in over two years, falling by 6 and 4 per cent respectively. Russian stocks also dropped by similar amounts reaching their lowest level in two years, resulting in the authorities in Russia to suspend trading on 17 and 18 September 2008. For that entire week, the stocks of most emerging market countries showed significant declines. Those included Israel (-10,8 per cent); Romania (-7,3 per cent); Thailand (-4.5 per cent); South Africa (-2,9 per cent); Hungary (-2,1 per cent); Czech Republic (-2,0 per cent); Poland and Turkey (-1,9 per cent) and Korea (-1,5 per cent).

Emerging Market Bond Indices (EMBI) spreads over US Treasuries widened sharply during the week under review. The widest spreads were recorded in Russia (52 bps); Argentina (42 bps); Venezuela and Ukraine (30 bps) and China (28 bps). South Africa and Poland registered the smallest movements with their spreads over US Treasuries widening by some 5bps.

The currencies of most emerging markets weakened considerably against the USD during the week starting on 15 September on the back of major equity and bond selling in these countries. The biggest depreciations were registered by Chile (-3,2 per cent) followed by Brazil (-2,0 per cent) and Iceland (-1,5 per cent).

In the year to date, non-residents have been net sellers of equities to the value of around R52 billion, while net bond sales have totalled almost R17 billion. However it is important to note that these sales do not necessarily translate into actual capital outflows.

There is little doubt that the traditional source of foreign capital inflows, that is flows into the equity market, may remain under pressure in the coming months as a result of continued risk aversion. Despite the global turmoil, the financial account in South Africa has remained in positive territory. While the deficit on the current account of the balance of payments remains at elevated levels, some pressure on the import side will be taken off by growth, lower oil prices and the poor performance of the rand. Unfortunately, with a rapidly slowing global economy, commodity prices are expected to remain subdued, and the export markets for commodities and manufactured goods in the current climate will remain a challenge.

Conclusion

Your Excellencies
Esteemed Ladies and Gentlemen
Colleagues

We are living through the most severe economic crisis in our living memory. In response, many governments and central banks have taken extraordinary measures to protect their banking systems and their economies. However the past few months have shown that increased global economic and financial integration has resulted in an increasingly interdependent world.

Over the last three years, the focus has increasingly been turned to the G-20 to provide leadership on international financial issues, and this was even more so the case during the current financial turmoil. While the G-20 is still a relatively small grouping, it nevertheless represents almost 90 percent of global trade and GDP respectively. On the other hand, the G-7 has proven itself to be an increasingly necessary albeit insufficient forum in the changing

economic environment of today. Hence, the current financial global crisis provides us with a fresh and unique opportunity to review what the role of global institutions and other cooperative arrangements should be.

It is clear that the need to act with the necessary resolve and in a cooperative fashion together with institutions such as the IMF, the BIS and the FSF and the G-20 is imperative in order to come up with action plans which should be implemented urgently and comprehensively. New global governance structures that are inclusive of all stakeholders are needed.

Recently the G-20 Heads of states met in Washington DC to discuss the global financial crisis. At this G-20 Economic Crisis Summit, the Heads of States resolved that countries should work together to restore financial stability and economic growth. The key issues agreed to at the summit were: the reform of the international financial institutions such as the World Bank and IMF; the conclusion of the global free trade agreement; improvement in financial market transparency; changing incentives so that excessive risk taking is no longer rewarded; drawing up a list of financial institutions that could result in systematic failure; and strengthening financial market regulation.

In the meantime, strong and significant actions have been taken in both advanced and emerging market economies to stimulate economies, strengthen the financial sector, provide liquidity and working to ensure that international financial institutions can provide support for the global economy.

In addition, the leaders endeavoured at this summit to provide further assistance and to support the global environment by stating the following and I quote:

> "Against this background of deteriorating economic conditions worldwide, we agreed that a broader policy response is needed, based on closer macroeconomic cooperation, to restore growth, avoid negative spillovers and support emerging market economies and developing countries. As immediate steps to achieve these objectives, as well as to address longer-term challenges, we will:
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> Continue our vigorous efforts and take whatever further actions are necessary to stabilise the financial system.
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> Recognise the importance of monetary policy support, as deemed appropriate to domestic conditions.
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> Use fiscal measures to stimulate domestic demand to rapid effect as appropriate while maintaining a policy framework conducive to fiscal sustainability.
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> Help emerging and developing economies gain access to finance in current difficult financial conditions, including through liquidity facilities and programme support. We stress the International Monetary Fund's (IMF) important role in crisis response, welcome its new short-term liquidity facility and urge the ongoing review of its instruments and facilities to ensure flexibility.
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> Encourage the World Bank and other multilateral development banks (MDBs) to use their full capacity in support of their development agenda and we welcome the recent introduction of new facilities by the World Bank in the areas of infrastructure and trade finance (and)
>
> Ensure that the IMF, World Bank and other MDBs have sufficient resources to continue playing their role in overcoming the crisis."

The next G20 Head of State summit to review progress will be held by 30 April 2009.

Hopefully by the time we meet next year, we will be able to report on more promising global and domestic developments.

Please enjoy the rest of the evening, and may you have , in the period ahead, a wonderful festive season and a prosperous New Year.

'Till we meet again! Adios Amigos!

Thank you very much.