Gill Marcus: Crisis and confidence

Address by Gill Marcus, Governor of the South African Reserve Bank, to the Nordic Business Chamber of South Africa, Johannesburg, 2 October 2012.

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Good afternoon, and thank you for the invitation to address you today.

As you know, on the 20th of September we made our latest interest rate decision. As with all of our deliberations on the Monetary Policy Committee, this decision to keep rates at the current level was not an easy one. The global economy remains a source of extreme uncertainty, while the domestic economy is beset by its own challenges – some related to the travails of the rest of the world and others home-grown. I thought it might be useful to speak today about current economic conditions and our latest interest rate decision, before moving on to say a few words about rebuilding confidence in our economic future.

Crisis

The global growth outlook has weakened in recent months, despite some moderation in the risks surrounding Europe's financial situation. The European Central Bank, the Federal Reserve and the Bank of Japan have launched new programmes to add liquidity to key markets and to encourage economic growth.

The QE3 decision by Chairman Bernanke and the FOMC seeks to improve outcomes in a US labour market struggling with slow growth. But the economic outlook going forward is weak, clouded over by the risk that the US will walk over a "fiscal cliff" of combined tax increases and spending cuts, causing a sharp slowing in US growth. Despite renewed stimulus in the United States and agreement to continue funding the government until March 2013, growth is expected to remain subdued at least until the "fiscal cliff" issue is resolved.[1]

In the Eurozone, the immediate risks posed by the continuing debt crisis appear to have abated somewhat. The ECB's Outright Monetary Transactions (OMT) programme, the decision of the federal constitutional court in Germany to uphold the ratification of the treaty to establish the European Stability Mechanism, and the pro-euro outcome of the Dutch election have lent some stability to the zone. Nonetheless the risk of a Greek exit from the Eurozone remains high, and growth prospects in the region have deteriorated as banks deleverage further and cross-border lending falls.

Growth has also slowed in some of the systemically important emerging market economies, particularly in China, Brazil and India.

In line with weaker growth worldwide, global inflation remains relatively benign. And yet supply side shocks in the form of higher food prices, due to droughts in the US and some parts of Eastern Europe, and resilient international crude oil prices pose potentially serious risks to the outlook. The combination of slowing growth and rising prices presents difficult challenges for monetary policy.

Global conditions impact on South Africa, and this, alongside domestic factors, has been reflected in our own downward revisions to the forecast for domestic economic growth. For 2012 we expect the economy to grow by about 2.6 per cent, rising to 3.4 per cent in 2013 as the global economy starts to recover.

The economy grew by 3.2 per cent in the second quarter of 2012, but this reflects a distortion arising from the strong contribution from the mining sector which recovered from a deep contraction in the first quarter. Non-mining real output growth measured a low 1.7 per cent.

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[1] The US Congress passed a "continuing resolution" which authorizes funding of the US government through March 2013 at current spending levels. This provides room for discussion about the scheduling of withdrawal of tax cuts and enactment of spending cuts over the next few months without the risk of needing to address a government shutdown. It does not remove the fiscal cliff.

Household spending continues to provide much of the growth in the economy. Investment strengthened in the latter half of 2011 and growth has been sustained into 2012, rising by 5.7 per cent in the second quarter of this year. However, private sector gross fixed capital formation remains weak, with the balance of growth in investment arising from activities of public corporations.

Job creation has picked up, but again remains sluggish. Statistics South Africa shows 123,000 jobs created from mid-year 2011 to mid-year 2012, about one third of which were in the public sector. The current level of formal sector employment is still about 60,000 less than that reached before the onset of the crisis.

The stronger growth in the domestic economy that we saw in the first half of 2012 was reflected in better credit extension figures. These have since moderated from 9.2 per cent in March, to 7.3 per cent and 7,8 per cent in July and August respectively. Credit extension to households rose by 8.1 per cent in July and 9,0 per cent in August, while credit extended to the corporate sector eased somewhat. Mortgage loans remained subdued, while instalment sale credit and leasing finance reflect robust vehicle sales. Unsecured lending has continued to rise rapidly, although again somewhat slower in recent months than in the first quarter of this year.

Partly as a result of this lending, household debt as a ratio to disposable income increased slightly, from 75.6 per cent to 76.3 per cent between the first and second quarters of 2012. The asset quality of the banking sector however remains sound. Impaired advances as a percentage of gross loans and advances measured 4.4 per cent in July 2012 compared with 5.5 per cent a year earlier.

The trends in wage growth have been relatively benign from an inflation perspective, with nominal unit labour cost growth of 6.1 per cent in the first half of 2012 compared to a year earlier. However, there is a risk that the recent wage settlements in the mining sector could set a precedent for wage demands more generally.

We expect consumer prices in South Africa to remain contained within the target range over the forecast period. The decline in inflation in recent months to 4.9 per cent in July appears to have stopped with the August outcome of 5.0 per cent.

Food and petrol prices continue to be the main drivers of consumer prices, set largely in international markets and then feeding through into South Africa. Food prices increased by 5.1 per cent, petrol by 9.3 per cent and electricity by 10.0 per cent in the year to August. Core inflation, as measured by the exclusion of food, petrol and electricity from CPI measured 4.6 per cent, up from 4.5 per cent in July. Administered prices excluding petrol increased at a year-on-year rate of 7.5 per cent.

The inflation forecast of the Bank reflects a moderate deterioration for 2013 compared with the previous forecast, and a relatively flat trajectory over the entire forecast period. Inflation is now expected to average 5.3 per cent in the final quarter of 2012 and 5.6 per cent for the year, 5.2 per cent in 2013, and 5.0 per cent in 2014. Inflation expectations continue to be roughly in line with the Bank's forecast, although anchored near the upper end of the 3 to 6 per cent target range.

The rand exchange rate has fluctuated generally within a range of R8.10 and R8.50 against the US dollar since May, and continues to be affected by changing risk perceptions in global financial markets and domestic issues, such as the tragic events at Marikana.

Capital flows into South Africa remain robust this year, rising by a net R72.5 billion. Investor interest in emerging market debt and South Africa's inclusion in the Citibank World Government Bond Index (WGBI) have contributed to the inflows. In recent months, the rand depreciated against the euro by about 7.5 per cent and about 2.4 per cent against the US dollar.

The current account of the balance of payments has emerged as a risk to the exchange rate outlook following the widening of the deficit to 6.4 per cent of GDP in the second quarter. This widening deficit is a consequence of declining commodity exports and increased imports and service payments. We expect the current account for 2012 to moderate somewhat to about 5¼ per cent of GDP.

Food and petrol prices continue to be the main upside risks to the inflation outlook. Following a sharp spike in July, global grain prices appear to have stabilised and then moderated

somewhat. Domestic prices of maize and wheat have followed global trends, increasing by about 40 per cent and 20 per cent respectively between the beginning of June and the end of July. These increases are expected to filter through to domestic consumer prices in the coming months.

Following sharp decreases in petrol prices earlier this year, since August, the price of petrol has increased by a cumulative R1.15 per litre. A further increase is expected in October. These petrol price increases are driven by international oil prices, which reached US$117 per barrel on 14 September.2

Oil prices have moderated in recent days to US$110 per barrel as Saudi Arabia committed to increase the supply of oil, but geo-political factors will remain a source of underlying volatility in the oil price.

Creating confidence

With this backdrop in mind, let me turn now to say a few things about how we might think about steps to improve confidence in South Africa and the region.

As some of you will know, we participate in many international forums, the G20, the governors' board of the IMF, the Financial Stability Board in Basel and the Bank for International Settlements, among others. Participation enables us to give voice to our concerns about the trajectory of the world economy, make suggestions on how to approach or resolve problems, and influence the development of regulatory frameworks that affect us. And yet, there is little or nothing we can do, other than express our views, to help other countries find their way out of the difficult prevailing economic circumstances.

The spill over of global factors to our economy can be profound, changing the size and direction of capital flows, global inflation, trade, commodity prices, and more.

This means that as South Africans, we need to develop the policy and regulatory frameworks, and adjust our policy stance, to do as much as we can to offset harmful economic effects from abroad while taking advantage of the beneficial dynamics. Above all, it means encouraging local economic growth and development, including the development of an active, integrated regional economy.

Our basic macroeconomic policy framework cushions against global economic shocks. It allows for flexibility in our approach to achieving the inflation target. The Reserve Bank has the responsibility and the latitude to identify and understand shocks to consumer prices as being temporary or permanent, and to view inflation pressures alongside economic conditions and developments in key markets. The gap between the economy's potential growth rate, which is currently 3,5 per cent, and its actual growth performance is an important factor in understanding the domestic economy. South Africa's economic stability is further supported by a macroprudential framework that has adjustable limits to the foreign currency exposure of South African households and institutions.

The inflation targeting framework allows the exchange rate to be determined more fully by market forces than under a policy framework that tries to fix the currency. This has various advantages, with perhaps the key one being that movements in the currency help to moderate the very forces causing the currency's value to move. When the currency depreciates, moreover, the costs to some economic agents are balanced by gains to other agents, like exporters. This in turn reduces the cost of international contagion to the domestic economy.

This is a lesson learned well in some Nordic economies. Exchange rate flexibility has critical macroeconomic advantages for small open economies that either have diversified trade and financial connections to other economies and regions, or that desire some autonomy to determine their own monetary policy. Sweden and Norway, for instance, have extensive trade ties with the Eurozone but also with North America and Russia. Economies much more closely integrated with larger dominant economies may find fixed exchange rates a more useful way of maximizing the economic gains of their relationship to the main trading partner.

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[2] Or USD$12 per barrel higher than at the time of the July MPC.

The floating currency and independent monetary policy become especially beneficial for economies that need to adjust to negative economic shocks – both self-imposed and external. Sweden discovered this as it adjusted to a severe balance of payments crisis in the period after 1991.[3] It enabled Swedish banks and industry to restructure at a more favourable exchange rate and allowed the economy to achieve a more sustainable long-run growth path. The current global crisis provides further support to this notion. Sweden's growth rate rebounded post-crisis, but should be roughly in line with its average over the previous decade as the global economy recovers in coming years.

In South Africa's case, the floating currency supported economic growth in the wake of the Argentine crisis of 2001, and in the current crisis the economy suffered a quite modest decline in the economy of 1.7% in 2009. Other factors also played an important role in supporting the economy in this period, including counter-cyclical fiscal policy and sustained high commodity prices.

Real currency depreciation is, however, only one part of what it takes for economies to weather adverse shocks or to counter domestic economic developments that weaken competitiveness. Achieving a new sustainable economic growth rate after a shock or internal adversity requires economic adjustment – changes in rates of return to different economic activities and shifts in labour and capital between those activities. Adjustment should be easier to achieve when an economy is reasonably diversified. For South Africa, large commodity, manufacturing, financial and services sectors helps to keep the economy going even when one or more of them runs into trouble.

This economic diversification is also critical to thinking about where to get the financial means to assist the economic adjustment process. And here an important idea comes from Norway, with which South Africa shares a commonality in a strong natural resource base. The idea is to shepherd natural resource earnings and use it for long term, inter-generational, development. There are various ways this use of resource rents can be channelled into higher welfare, through direct transfers of income to households, stronger communitarian claims on private sector firms involved in extraction, or through more highly developed public services.

But achieving anything via these channels depends on some ground rules being set out and protected in policy, regulation and/or law. One ground rule is the approach taken by the fiscal authorities to set the taxation of the resource rent at a level commensurate with sustainable long-term extraction and the life of the endowment. Another ground rule is how to manage the pay out of the revenues accruing from the resource. The benefit to citizens needs to spread over generations, rather than consumed up-front. This implies that public borrowing needs to be carefully managed to ensure that future resource revenues are not committed in advance to debt repayment. A focus on long-run infrastructure development by the public finance authorities could help to ensure that additional borrowing pays back the debt without reducing the benefit of future resource revenues for future generations.

Once all that is in place, how do we benefit from the resource endowment? Clearly there are various options, with spending to enhance the potential growth rate of the economy the most important. But where should we focus such efforts? In my view, the greatest gains over the longest period of time are likely to come out of efforts to develop a well-integrated regional economy, founded on real economy links of trade, transport, telecommunications, energy, and labour mobility. These are the fundamentals that enable talent to find opportunity and firms to grow.

This kind of focus is a far cry from the integration vogue of the last 20 years, which emphasised the integrating-effects of common monetary systems. Greater regional economic integration should not be founded on common monetary arrangements. Sweden implicitly recognized that it was not feasible to be part of a European economic arrangement that approximated an optimal currency area. And, that after monetary union, it was unlikely that the common

[3] In 1991, Sweden's economy contracted by –1.0%, in 1992 by –1.2, and in 1993 by over –2%. For the remainder of the 1990s it grew by an average of nearly 4% per year. The average annual growth rate slowed to about 2.75% in the 2000s, prior to the crisis. Annual growth rates were –0.61, –5.0, +6.1, and +3.9 from 2008 through 2011. Finland had a much larger fall in 2009 (–8.3%), while Norway's was comparable to SA at –1.7%.

currency would generate the optimal currency area conditions. This was prescient of course as the Eurozone's present circumstances show.

In the Southern African Development Community a set of ambitious programmes were drawn up and agreed about 10 years ago, including moving to the Africa-wide monetary arrangements (agreed by the African Union), a Regional Indicative Strategic Development Plan, and a macroeconomic convergence framework. The macroeconomic convergence framework deliberately eschewed formal mechanisms for forcing convergence on the grounds that asymmetric shocks to regional economies would dominate and more formal arrangements would lack credibility. Without considering optimal currency area criteria, a convergence programme needed to be more of a peer review mechanism where policy dialogue and sharing of ideas could occur rather than an exercise in grilling wayward economic officials.

As a peer review mechanism, the convergence programme should generate some benefits to SADC members. At the same time, however, African monetary integration initiatives are still going ahead in various forums, for example initiatives by SADC and the AU, with different and overlapping timetables, and with inordinate haste in some instances. Unfortunately the thinking behind these initiatives continues to ignore the criteria for optimal currency areas.

An important lesson of the European crisis is that macroeconomic convergence is not enough. Fiscal conditions need to be supporting of macroeconomic convergence and of monetary arrangements, and institutions built to ensure that fiscal policy sustains those conditions over time. While the need for harmonised fiscal policies was recognised by the architects of the Eurozone, the issue was dealt with through the Stability and Growth Pact, which has turned out to be a loose, often ignored and unenforceable agreement that countries would abide by certain fiscal guidelines. We have seen the implications of the lack of a centralised fiscal authority, or fiscal counterpart to the ECB. Reaching agreement on, and implementing monetary policy is difficult enough. Fiscal policy is far more complex and political, as it involves policy levers that have more pervasive distributional impacts.

At the end of the day, the hard work of developing markets, laying out infrastructure, and enabling the flow of factors of production will develop our regional economy more effectively than any monetary arrangement or international institution to enforce sound fiscal policy. Such economic integration initiatives can be supported by a sustainable and far-sighted resource revenue policy.

Efforts to develop the regional economy need greater impetus. It is not hard to see why. South Africa's long-standing economic ties to Europe and North America, important as they are, made it vulnerable to the collapse of these economies.

African economies have displayed remarkable resilience during the crisis. Although most countries experienced lower growth, mainly a result of lower global commodity prices, in general they managed to avoid recession. Unlike South Africa, the trade channel was less important because of the predominance of intraregional trade, and the stronger trade links with Asia. Since then, most sub-Saharan African countries have returned pre-crisis growth rates, in line with those in developing Asia.

Africa is the second-fastest growing region in the world, and this looks likely to continue for some time. Foreign direct investment into Africa remains quite high, at USD$42.7 billion last year. This is lower than at its peak of USD$57.8 billion in 2008 but still robust, and reflects a fall-off in investment to parts of North Africa. For Sub-Saharan Africa, FDI declined from the USD$34.7 billion achieved in 2008 to USD$27 billion in 2010 and then rebounded to USD$35 billion in 2011. The rebound was caused by large inflows to South Africa (USD$5.8 billion) and Nigeria (USD$8.9 billion).[4] Direct investment into Africa will continue to grow as oil and gas exploration continues to expand known reserves and markets for telecommunications and other services are opened to competition.

Our goal should be to expand trade broadly but not in the interest of trade diversion, but to grow the level of economic activity in South Africa, the region, and farther flung trading partners

[4] FDI inflows to Africa are highly concentrated with eight countries, including Algeria, the Congo, Ghana, Morocco, Mozambique, Nigeria, South Africa and Zambia receiving more than 70 per cent of the total FDI inflows in 2011. South Africa and Nigeria accounts for more than 40 per cent of the FDI inflows to SSA in 2011.

like the Nordic economies. Africa still has a multiplicity of, and in some instances overlapping regional trade blocs, and has some way to go to achieve full trade integration. Further trade integration in Africa should be pursued more purposefully, supported by network industry development.

Conclusion

Confidence is a critical factor in whether our economies sink or swim. South Africa has in place a range of policy frameworks and a fairly developed level of diversification that cushions the domestic economy from adverse international conditions. These create confidence for domestic businesses and have in recent years contributed to inflows of capital from abroad. We need to build confidence much more, however, by ensuring that the people behind the numbers are able to respond to the demands of economic adjustment in constructive ways. Using our resources wisely can provide the means for developing our human capabilities over successive generations, in part by developing markets and creating economic opportunities across the region.

Thank you.

19 September 2012 **GDP**
Annual percentage growth rate

Year	**Sweden**	**Norway**	**Finland**
1971	0.94	5.62	2.36
1972	2.29	5.27	7.74
1973	3.97	4.48	6.98
1974	3.2	3.82	3.24
1975	2.55	5.03	1.8
1976	1.06	5.79	0.34
1977	-1.6	4.14	0.24
1978	1.75	3.85	2.92
1979	3.84	4.36	7.12
1980	1.7	4.5	5.39
1981	-0.2	1.55	1.29
1982	1.19	0.12	3.05
1983	1.81	3.87	3.02
1984	4.27	5.89	3.11
1985	2.19	5.35	3.3
1986	2.86	4.04	2.64
1987	3.46	1.78	3.49
1988	2.67	-0.17	5.22
1989	2.78	1	5.08
1990	1.01	1.93	0.51
1991	-1.12	3.11	-6
1992	-1.2	3.52	-3.48
1993	-2.06	2.79	-0.81
1994	4.01	5.05	3.65
1995	3.94	4.19	3.96
1996	1.61	5.1	3.57
1997	2.71	5.39	6.21
1998	4.2	2.68	5.03
1999	4.66	2.03	3.91
2000	4.45	3.25	5.32
2001	1.26	1.99	2.28
2002	2.48	1.5	1.83
2003	2.34	0.98	2.01
2004	4.23	3.96	4.12
2005	3.16	2.59	2.92
2006	4.3	2.45	4.41
2007	3.31	2.65	5.34
2008	-0.61	0.04	0.29
2009	-5.03	-1.67	-8.35
2010	6.13	0.68	3.73
2011	3.94	1.6	2.85

Table 1: FDI inflows by region, 2009-2011 (Billions of US dollars)

	2006	2007	2008	2009	2010	2011
Developed economies	981.9	1 310.4	1 019.6	606.2	618.6	747.9
Developing economies	427.2	574.3	650.0	519.2	616.7	684.4
Africa	36.8	51.5	57.8	52.6	43.1	42.7
North Africa[1]	23.2	23.9	23.1	18.2	15.7	7.7
Algeria	1.8	1.7	2.6	2.7	2.3	2.6
Egypt	10.0	11.6	9.5	6.7	6.4	-0.5
Libya	2.1	3.9	3.2	3.3	1.9	-
Other	9.3	6.8	7.8	5.5	5.2	5.6
Sub-Saharan Africa[2]	13.6	27.5	34.7	34.4	27.4	35.0
West Africa	7.0	9.6	12.6	13.5	11.8	16.1
Ghana	0.6	0.9	1.2	1.7	2.5	3.2
Nigeria	4.9	6.1	8.2	8.7	6.1	8.9
Other	1.5	2.6	3.1	3.1	3.2	4.0
Central Africa	2.8	5.9	4.2	6.2	9.5	8.5
Chad	-0.3	-0.1	0.2	1.1	1.9	1.9
Congo	1.9	2.3	2.5	1.9	2.2	2.9
Congo, DR of	0.3	1.8	1.7	0.7	2.9	1.7
Other	0.9	1.9	-0.3	2.6	2.4	2.1
East Africa	2.4	4.0	4.2	3.8	3.7	4.0
Madagascar	0.3	0.8	1.2	1.1	0.9	0.9
Tanzania	0.4	0.6	1.2	1.0	1.0	1.1
Other	1.7	2.7	1.8	1.8	1.8	2.0
Southern Africa	1.4	8.1	13.7	11.0	2.4	6.4
Angola	-	-0.9	1.7	2.2	-3.2	-5.6
Mozambique	0.1	0.4	0.6	0.9	1.0	2.1
South Africa	-0.5	5.7	9.0	5.4	1.2	5.8
Zambia	0.6	1.3	0.9	0.7	1.7	2.0
Other	1.2	1.5	1.5	1.8	1.7	2.1
East and South-East Asia	195.9	236.6	235.5	206.6	294.1	335.5
South Asia	27.9	34.7	52.9	42.4	31.7	38.9
West Asia	67.1	78.1	92.0	66.3	58.2	48.7
Latin America and the Caribbean	98.2	172.3	209.5	149.4	187.4	217.0
Transition economies	54.3	90.8	121.0	72.4	73.8	92.2
World	1 463.4	1 975.5	1 790.7	1 197.8	1 309.0	1 524.4

[1] Including Sudan and South Sudan.

[2] In the United Nations' terminology, sub-Saharan Africa (SSA) refers to the countries of East, West, Southern and Central Africa plus Sudan and South Sudan in North Africa. However, SSA in this table excludes Sudan and South Sudan.

Source: UNCTAD *World Investment Report* 2012

Trade relations between South Africa and the Nordic countries

- South Africa's exports to Nordic countries has increased by 338,2 per cent from R1,9 billion in 2000 to R8,2 billion in 2011.
- The most important export destination in the Nordic countries in 2011 was Sweden (27,5% of total exports to Nordic countries), Finland (27,4%) and Norway (23,7%).
- South Africa's imports from Nordic countries has increased by 188,3 per cent from R6,6 billion in 2000 to R19,0 billion in 2011.
- The most important source of imports for South Africa among the Nordic countries is Sweden (66,8% of total imports from Nordic countries) and Finland (18,8%).

Major commodities exported to Nordic countries in 2011

(In alphabetical order)

Denmark	Bituminous coal Wine
Finland	Copper ores and concentrates
Iceland	Bituminous coal
Norway	Other ores and concentrates Manganese ores and concentrates
Sweden	Wine

	Motor vehicle (Diesel double-cab) Ferro-chromium

Major commodities imported from Nordic countries in 2011

Denmark	Pharmaceutical products Mechanical appliances Pumps
Finland	Cellular telephones
Iceland	Pharmaceutical products
Norway	Commemorative medallions Electrical machinery
Sweden	Aircraft Motor vehicles Pharmaceutical products Boring/sinking machinery

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