Gill Marcus: The economic and financial outlook for the South African economy

Address by Ms Gill Marcus, Governor of the South African Reserve Bank, at the workshop on "The outlook for financial markets, for their governance and for finance", Cernobbio, Italy, 8–9 March 2013.

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Thank you for the opportunity to speak to you in this beautiful environment. It is hard to believe that we are in the epicentre of a global financial crisis that is now entering its sixth year, and that Italy itself is grappling with what appears to be a period of Italian political instability against a backdrop of an economy that contracted by around 2,4 per cent in 2012, and within a challenging Eurozone environment.

The continued synchronized downturn in the major advanced economies – the US, Eurozone, Japan and the UK – will impact on the global outlook for some considerable time. It is to the United States that we look to build on its slow recovery and begin to lead the advanced economies out of this very difficult economic environment. And we all need to recognise the way in which the global financial crisis has mutated and that, even if there is no further deterioration in the outlook, it is going to take many years to recover.

While the crisis originated in the advanced economies, the impact differed across countries. The nature and scale of the spillover effects have been dependent on the extent of trade and financial linkages. The crisis and the continued weakness in the advanced economies have also underlined the need for emerging economies to diversify traditional trade and financial relationships. This is part of the rationale underlying the formalisation of the BRICS grouping (Brazil, Russia, India, China and South Africa), as well as the reorientation of South Africa's trade relations towards the rest of the African continent.

Growth in sub-Saharan Africa, apart from South Africa, was remarkably resilient during the crisis. Although most countries experienced lower growth, mainly due to lower commodity prices, in general they managed to avoid recession. Unlike South Africa, the trade channel was less important because of the predominance of intra-regional trade, and stronger trade links with Asia.

Most sub-Saharan African countries have returned to pre-crisis growth rates due in large part to the recovery in commodity prices. This positive trend is expected to be sustained in most of the region. According to the latest World Economic Outlook, economic growth in sub-Saharan Africa is expected to average 5,8 per cent in 2013 and 5,7 per cent in 2014. Oil-exporting countries, of which Nigeria and Angola are but two, are expected to continue to grow at rates in excess of 6 per cent.

South Africa has been able to benefit from these favourable developments and we have seen significant shift in trade patterns in recent years. In 2007, 38 per cent of South African manufactured exports went to Europe, with 25 per cent going to Africa. By 2012 the picture had reversed, with 25 per cent going to Europe, and 38 per cent going to Africa. The impact of the recession in Europe, for example, has been felt particularly hard in the motor vehicle export sector. However the decline in exports to Europe in 2012 was more than compensated for by a 19 per cent increase in vehicle exports to Africa in that year.

The focus of South Africa's regional interactions has not only been on the trade side. Foreign Direct Investment in the region grew from less than US$1 bn in 1990 to almost US$40 bn in 2012. South African companies have been very active in this respect and have increasingly made their presence felt on the continent in mining, the retail sector, construction, telecommunications, agri-business and banking in particular. According to a recent Ernst & Young survey (Building Bridges: Ernst & Young's 2012 attractiveness survey: Africa), South African companies featured in the top 5 investors in FDI in Africa in 10 of the 14 sub-Saharan

African countries surveyed. By 2011 the value of South African FDI in sub-Saharan Africa amounted to 6 per cent of South African GDP. South African-based banks have subsidiaries in 16 countries in the region, and according to the IMF, in 11 of those countries South African subsidiaries are among the five largest banks.

These growing regional ties have, however, only partially insulated the South African economy from the global slowdown. Following a brief crisis-induced recession in 2009, economic growth recovered, but at lower levels than were the case in the few years prior to the crisis. The economy grew by 3,5 per cent in 2011, but moderated to 2,5 per cent in 2012. The output gap remains negative, and with growth expected to remain below potential (3,5 per cent) this year, the gap is not expected to be closed within the Bank's forecast period ending 2014. The Bank's latest forecast is for growth of 2,6 per cent in 2013 and 3,8 per cent in 2014. The more favourable outcome for next year is predicated, to a significant degree, on a stronger recovery in the advanced economies, particularly in Europe. Therefore this forecast is subject to downside risk.

Part of this disappointing growth story has been due to weak global demand for South Africa's exports, combined with the impact of low advanced economy interest rates on the exchange rate. The consequent global search for yield contributed to the appreciation of the currency for an extended period until around April 2012 which negatively affected South Africa's competitiveness. This adverse trend was reinforced by domestic factors including higher input costs of electricity, transport and labour, as well as a decline in the terms of trade since 2010. These factors contributed to the widening of the current account of the balance of payments from 2,8 per cent of GDP in 2010, to 6,4 per cent in the second and third quarters of 2012. The value of merchandise exports declined by 6,6 per cent between the fourth quarter of 2011 and the third quarter of 2012, while the value of merchandise imports increased by 4,4 per cent. Net exports have contributed negatively to recent growth.

South Africa has been seen as a particularly attractive investment destination because of its well-developed financial system, including its foreign exchange and capital markets. Furthermore, the depth and liquidity of the foreign exchange market, with a daily turnover of about US$17 billion, made it attractive for hedging emerging market risk, which contributed to the volatility of the exchange rate.

While other emerging markets were implementing measures to stem these inflows, such measures were not seen to be appropriate in the South African case given these structural features. Although we did not intervene directly to prevent the appreciation, we did take advantage of these circumstances to add to our holding of foreign exchange reserves, with gross reserves increasing from US$34 billion in 2008 to current levels of around US$50 billion.

For most of the 2000s, portfolio investment into South Africa was dominated by equity inflows, while inflows into the bond market were relatively small. However, as emerging economy bond markets became more attractive, this pattern changed. Inflows into the bond market were given additional impetus with South Africa's inclusion in the Citibank World Government Bond Index in 2012, when bond flows totaled R88 billion (compared with R47 billion in 2011) , more than offsetting a net outflow of equities to the value of R3 billion. While bond inflows also declined in the last two months of 2012, both bond and equity inflows have resumed on a moderate scale, and totaled R18 billion in the first two months of this year. Non-resident investors now hold 36 per cent of South African government bonds, up from 13 per cent in 2008.

In response to these inflows, the rand appreciated by almost 30 per cent against the US dollar between the beginning of 2009 and March 2012, although around a volatile trend. For much of the period, the rand moved in line with other liquid emerging market currencies, particularly the Mexican peso and the Brazilian real. These currencies were highly sensitive to the so-called "risk-on" and "risk-off" scenarios, particularly relating to risk perceptions of the Eurozone. This co-movement in effect indicated that the underlying movements of the rand were determined to a large degree by external rather than internal factors.

Since April 2012, however, domestic factors have come more to the fore. The rand has decoupled from its emerging market counterparts and has depreciated by about 15 per cent against the US dollar and by a similar amount against the Mexican peso. The rand initially depreciated in response to the widening of the deficit on the current account of the balance of payments but depreciated further largely as a result of a rising risk premium, following protracted labour disputes in the mining and agricultural sectors in particular, as well as downgrades by the three main ratings agencies.

While the depreciation should help to reduce the current account deficit, the adjustment will not be easy given the slow or negative growth in the advanced economies. The deficit is expected to persist for some time, although at a narrower, more sustainable level in the face of the import-intensive nature of South Africa's infrastructural investment expenditure. Such expenditure is seen as growth enhancing, and therefore sustainable on an inter-temporal basis.

The underlying reasons for capital flows to emerging markets remain, and are likely to persist for some time. Furthermore, with increased certainty about the domestic policy framework, the risk premium is expected to decline. However, as financial markets are highly sensitive to changing developments, sentiment can change very quickly, and so too the direction and quantum of flows as can be seen from the financial markets' reaction to the recent FOMC minutes that were interpreted as a signal of an earlier-than-expected reversal of quantitative easing.

The main export sectors of the South African economy therefore face a challenging outlook, from both external and internal sources. Commodity prices, apart from the gold price, have not generally recovered to pre-crisis levels. At the same time input costs, particularly electricity and wage costs, have risen significantly, contributing to the contraction in the sector in 2012. Furthermore the sector is beset by an increasingly difficult labour relations environment, which resulted in protracted industrial action in the final months of 2012. The manufacturing sector remains vulnerable to the continued weak demand from Europe while its import and export competitiveness was also adversely affected by the appreciation of the currency in 2010/11. Following the recent depreciation of the rand the outlook for the sector is more positive, but nevertheless fragile.

Where do South Africa's short term growth prospects lie? Investment by the private sector, which accounts for around two-thirds of gross fixed capital formation, remains constrained by relatively low levels of capacity utilisation in the manufacturing sector. Electricity supply constraints are also an impediment to investment growth, and are likely to remain so until new capacity, currently under construction, comes on stream during 2014.

The main impetus to growth is likely to come from infrastructure-related investment expenditure by the state-owned enterprises, which have a particular focus on power generation, road and rail transport, as well as port efficiencies and capacity. The National Treasury estimates that R827 billion will be spent on infrastructure over the next three years. A significant portion of this will be on electricity generation as well as the development of transport infrastructure, where rail transport is particularly lacking. A focus on infrastructure not only provides a boost for job creation, but also helps overcome some of the constraints to growth, improves economic efficiencies and increases the potential output of the economy.

Scope for further macroeconomic accommodation is relatively constrained. The fiscal space achieved by prudent fiscal policies prior to the crisis allowed for a counter-cyclical fiscal policy stance, but this space has been eroded. The budget deficit in the past fiscal year is estimated to have expanded to 5,2 per cent of GDP, compared with an initial estimate of 4,5 per cent, mainly a result of lower-than-expected tax revenues. Nevertheless the government remains committed to achieving a fiscal consolidation path, and expects the deficit to GDP ratio to decline to 3,1 per cent by 2015/16 . At the same time the net debt to

GDP ratio is expected to stabilise at around 40 per cent over the same period. These trends constrain the room for further stimulus.

As is the case in many countries, the lack of fiscal space inevitably raises expectations for further monetary accommodation. Monetary policy in South Africa is conducted within a flexible inflation targeting framework, with an inflation target band of between 3 and 6 per cent, set by government. Although our nominal policy rate at 5 per cent is above those in most advanced economies, the real policy rate is currently negative. Inflation averaged 5,6 per cent in 2012, and our forecast is that inflation is likely to temporarily breach the upper end of the inflation target range in the third quarter of 2013. We see the risks to the inflation outlook to be on the upside, coming primarily from the exchange rate depreciation and higher unit labour cost pressures. The relatively subdued growth outlook and the negative output gap have meant that we have been more tolerant of inflation at the upper end of the target range. However, our room for further accommodation is constrained by the need to keep inflation within the target over a reasonable time horizon.

The main challenge facing the economy remains the high level of unemployment, currently 25 per cent, with youth unemployment about double that. It is cold comfort that we are now in the same company as countries such as Spain and Greece, or that rising unemployment has become a major issue in many advanced economies. The persistence of the high rate of unemployment indicates that in South Africa it is a structural phenomenon, and therefore beyond the scope of monetary policy. The current low growth scenario is also insufficient to appreciably reduce unemployment. The government, together with all opposition parties in Parliament, has committed itself to a recently developed National Development Plan as the framework for growth going forward, which provides a coherent approach to help overcome some of the structural constraints in the economy. The main elements of the plan include various measures to increase employment creation; to increase the efficiency and capacity of the state; and initiatives to improve the quality of education.

It is perhaps appropriate at this point to make a few comments about the outlook for South Africa’s banking sector in the light of global regulatory changes. According to the World Economic Forum Competitive Survey 2012/13, South Africa was ranked third in terms of financial sector development and, within this category, the banking sector was ranked second in terms of soundness.

South Africa’s banking system remains strong, and at the beginning of this year we implemented Basel III. But the new global rules are not without their challenges. Our concern has been that changes to the Basel Committee rules, to which South Africa subscribes, are intended to solve problems in the banking systems of some of the advanced economies, but apply equally to countries such as South Africa that did not experience a banking crisis or regulatory failures, and could in fact cause unnecessary difficulties for the banks and for the broader macro economy. Nevertheless we are committed to complying with the Basel III requirements.

The Basel III Accord provides for higher capital ratios in order to ensure that banks are adequately capitalised. Currently South African banks’ capital adequacy ratios stand at 15,84 per cent, with a Tier 1 capital adequacy ratio of 12,55, which is well above the Basel III requirement of 4,5 per cent (and the domestic requirement of 6,0 per cent). Our banks also have a relatively low leverage multiple of 13,35 per cent.

Other provisions, however, will be more challenging. The liquidity coverage ratio (LCR) requires banks to have sufficient high-quality liquid assets to survive a month-long significant stress scenario. Studies by the Bank for International Settlements showed that South African banks generally would be short of such liquid assets by virtue of their dependence on wholesale, short-term funding. The Basel III liquidity framework does however give discretion to national supervisors to make available to banks a committed liquidity facility (CLF) at a fee against acceptable collateral. South Africa introduced such a facility for an amount of up to 40 per cent on any particular bank’s net cash outflows under stressed scenarios. This facility should prevent excessive increases in the cost of funding of banks and possible distortionary effects on the domestic financial markets.

We are, however, still concerned about the impact of the proposed net stable funding ratio (NSFR) which is expected to be implemented in 2018. Again, the structural features of our financial system may pose a challenge, given that most long-term saving in the economy is done through the non-bank financial institutions, which in turn provide short term deposits to the banks. However, we are not the only country with such concerns, and discussions with the Basel Committee on Banking Supervision are ongoing.

Although our banking system emerged relatively unscathed from the crisis, with no extraordinary measures needed to protect the banks or the financial system, we cannot be complacent. There is ongoing work to strengthen the regulatory architecture with a move towards a twin peaks model of financial regulation. This approach will see the consolidation of all prudential regulation of financial institutions within the Bank, while market conduct regulation of the financial sector will be consolidated within the Financial Services Board.

In conclusion, significant advances have been made over the past 18 years in alleviating poverty in South Africa by providing essential services to the poor and through an improved social security system. According to the recent census, marked improvements have been made, for example, with respect to the provision of housing, water and electricity with 85 per cent of South Africa’s population now having access to electricity, while 78 of our citizens now live in formal housing.

The OECD’s Survey of South Africa 2013 – released earlier this week – characterises South Africa as progressing, with good institutions and generally favourable momentum in important areas. However it also recognises sluggish economic growth coupled with rising inflation and an entrenched structural unemployment and inequality challenge.

South Africa is an extraordinary country of great contrasts. The Atlantic and Indian Oceans meet at the most southerly tip of the continent. The cold water current of the Atlantic and the warm water current of the Indian oceans perhaps reflect the contrasts that epitomise our country:

A country of great wealth and extreme poverty; of gold, diamonds, platinum and other mineral wealth that has contributed to the wealth of many nations; a country where the first heart transplant was performed, whose skills and expertise lead many fields of science, space, finance, business and the search for global and regional peace. It is a vibrant country full of hope and promise, but a country that has to rebuild its values in keeping with a constitution that entrenches democratic principles and respect for human life and dignity. The economy needs to grow faster and more inclusively, taking account of regional and continental opportunities. This is what we are committed to, and success will be in all of our interests as together we seek ways to break the stranglehold that the prevailing global crisis has on many parts of the world.

Thank you.