Daniel Mminele: Reflections on 2013 and challenges ahead for South Africa

Address by Mr Daniel Mminele, Deputy Governor of the South African Reserve Bank, at the Phalaborwa Chamber of Business Year-End Function, Phalaborwa, 1 November 2013.

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1. Introduction

Good evening ladies and gentlemen and thank you to the Phalaborwa Chamber of Business for the kind invitation to address you tonight. This was a particularly special invitation for me, as it brings me back home, back to the place of my birth, back to a place of good memories of a happy childhood. Phalaborwa and nearby Namakgale will always be very special to me.

It is indeed an honour not only to be given the opportunity to address you, but also to join you as we pay tribute, acknowledge and celebrate those who have been nominated for the various awards which will be presented tonight.

In my remarks tonight, given that the curtain is slowly coming down on 2013, I thought I would look back at the year that was, reflect on where we are and also on the challenges that lie before us, both on the domestic and international front.

2. Looking in the rear view mirror

For over six years now, the global economy has been operating in "crisis mode". The global financial crisis unfolded in three phases: the US subprime crisis, leading to a severe economic and employment crisis, and then mutating into a banking and sovereign debt crisis. These events spilled over into other advanced and emerging market countries, both through trade channels, by way of declining exports, negatively impacting growth and employment, and through financial linkages, which increased volatility in financial markets and led to uncertainty and declining confidence levels.

The South African real economy certainly felt the impact, being closely tied to the global economy through trade linkages, and also through financial linkages given our deep and liquid financial markets. The latter fact means that we are very often used as a proxy for other emerging market currencies, as the depth and liquidity of our markets makes it easier for investors to move in and out of South African financial markets. This fact also therefore partly explains the heightened volatility we experienced in recent years, and why volatility of the South African rand exchange rate tends to be generally more elevated than the volatility experienced with most other emerging market currencies.

On the economic front, South Africa lost proportionally more jobs during the recession than any other country more directly affected. The 2011 Budget Review showed that for a 2.6 per cent contraction in output during the crisis, South Africa's employment contracted by 7.5 per cent, which if measured as the responsiveness to a 1 per cent contraction in output, equated to –2.9 per cent. This was significantly higher than the list of 10 other countries compared. If one takes another emerging market country such as Turkey, which contracted by a much larger 12.8 per cent, employment contracted a lesser –1.8 per cent which for every 1 per cent contraction in output translates to –0.1 per cent.

As accommodative and unconventional monetary policy helped bring the global economy back from the brink, and the recession ended, stronger import demand was observed from trading partners. However, South Africa continued to lag behind and did not benefit as much from the increase in global trade as other emerging markets did, with export volumes failing to return to pre-crisis levels. The euro zone debt crisis weighed on South Africa's export recovery, exacerbated by domestic factors such as infrastructure bottlenecks and a lack of competitiveness. The situation grew decidedly worse during the second half of 2012 as our financial markets decoupled from global developments, following the tragic events at

Lonmin's Marikana mine. Wild-cat strike action spilled over to other parts of the platinum industry, later moving to rest of the mining sector, and to the transport and agricultural sectors, resulting in a significant dent in global investor confidence in the country, which contributed to sovereign credit ratings downgrades by all three major rating agencies, and ultimately resulted in a further weakening in the exchange rate of the rand and higher borrowing costs for the country.

In the absence of strong support from the export sector, domestic demand became the main driver of growth, supported by low nominal interest rates, rising disposable income and increased household debt levels. Fixed investment also provided a boost to growth, although this remained far below levels one would have liked to see, especially the private sector's contribution to fixed investment. Since 2009, South Africa's real GDP growth lagged that of other emerging markets, averaging 3 per cent as compared to the average of around 5 per cent for emerging markets.

As Phalaborwa is a mining town, and has had a long and rich history with the mining industry, allow me to say a little more about mining. The mining sector's contribution to real gross domestic product has halved since 1995, accounting for just over 5 per cent of GDP today. This fact does not make the mining sector irrelevant to the economy, far from it. The sector is important because it generates the bulk of foreign currency earnings – exports of minerals and metals account for approximately 60 per cent of all export revenue, hence the sensitivity of the foreign exchange value of the rand to mineral and metal prices and their production. Mining accounts for approximately one third of market capitalisation on the JSE; has been a strong attraction for Foreign Direct Investment and contributes handsomely to government's tax revenue. The mining sector has shed a fair amount of jobs in the wake of the Marikana debacle – in the period between December 2009 to June 2012, employment picked up from 488 000 to 534 000, but has since declined to 511 000 in the second quarter of 2013. Although employing just shy of 3 per cent of South Africa's total formal and informal labour force, the mining sector indirectly employs another 500 000 people, through linkages to other sectors, such as manufacturing.

Given the importance of the mining industry for our economy we can ill-afford the fractious labour relations environment and the violence we have seen.

3. Reflecting on 2013

As we entered 2013 there was a fair degree of optimism globally and locally, informed by some bold policy measures that had been taken in the latter part of 2012 and early 2013. In particular, the launch of the Outright Monetary Transactions programme (OMT) in the euro zone and in January 2013, as the US managed to avert the fiscal cliff. Both of these events provided a significant boost to confidence and helped to contain the most immediate threats to the global financial system, and thereby restored calm to financial markets. There was hope that reduced volatility in financial markets and improved confidence would eventually be transmitted into the real economy and provide for a more durable recovery. The domestic economy was expected to continue growing at a moderate pace (after a growth rate of 2.5 per cent for 2012), thanks to encouraging prospects for the global economy and improved sentiment following a successful ANC elective conference, which adopted the National Development Plan and provided some clarity in respect of policy positions around nationalisation in the mining industry.

The IMF's World Economic Outlook (WEO) released in January 2013 indicated that "Global growth is projected to increase during 2013, as the factors underlying soft global activity are expected to subside". Admittedly, the IMF also warned about downside risks that still remained. Based on data available so far, and recent information and developments in the global and domestic economy, a stronger recovery in 2013 will unfortunately in all likelihood turn out to be rather more elusive than what we had hoped for, and this is borne out by the latest release of the WEO which has seen a downgrade of global growth forecasts.

As we moved deeper into 2013, some of the headwinds identified by the IMF WEO and others as contributing to downside risks to the global outlook did indeed materialise, in particular expectations of an earlier than anticipated withdrawal of unconventional monetary policies by the US Federal Reserve. These headwinds also registered in the form of less progress being made in the eurozone on various fronts to help underpin the recovery there. More recently the picture is more promising, considering the euro zone has finally exited from a recession in the second quarter led by Germany and France, after six quarters of economic contraction. The Spanish economy exited two years of recession in the second quarter, growing by 0.1 per cent despite tough austerity measures which have brought thousands to the streets in protest. The US has been one of the more convincing bright spots when it comes to stronger underlying momentum in economic growth during 2013, although, like Japan, their fiscal outlook continues to weigh on future prospects. Slower growth rates in China, lower commodity prices, and moderating growth in emerging market economies, and generally a global economy moving at varying speeds across regions are some of the downside risks that have materialised.

On the domestic front, unfortunately risks that industrial action could become more widespread and disruptive during 2013 in the wake of wage negotiations in centralised bargaining agreements that were up for renewal also did come to pass and has damaged growth prospects for 2013. A dismal growth rate of 0.9 per cent was recorded in the first quarter of the year on account of a severe contraction in the manufacturing sector which was followed by a growth rate of 3 per cent in the second quarter, but which mainly related to normalisation in the manufacturing sector, and was not reflective of improving underlying economic conditions. The third quarter of this year will be affected by the widespread strike action experienced, but hopefully this will be partly offset by more improved growth performance in advanced economy trading partner countries, as noted earlier.

The rand exchange rate has been somewhat slow to act as a shock absorber or adjustment mechanism to provide support to the trade account and the Balance of Payments. South Africa's current account deficit widened from 2.8 per cent of GDP in 2010 to 6.3 per cent in 2012. The trade deficit grew on account of increased imports related to the infrastructure investment programme, and lacklustre exports, as well as declining terms of trade. The depreciation of the rand exchange rate resulted in a deterioration in the Bank's inflation outlook, and the targeted measure of inflation increased from just below 5.0 per cent in August 2012 to 6.4 per cent in August 2013. Still, however, there was little evidence of any demand pressures, with much of this increase driven by cost push factors.

It is the improvement in growth prospects for advanced economies, in particular the US, that saw the rand again recouple with global developments on talk of asset purchase tapering. Expectations of tapering had a profound impact on financial markets of both advanced economies and emerging markets, but more particularly for the latter as it is deemed that such a withdrawal of stimulus will negatively impact on portfolio flows to emerging markets. Indeed, capital inflows retreated somewhat, and in South Africa we witnessed a pull-back especially in bond inflows. During May and June this year, we witnessed a net outflow of over R17 billion from our bond market although this was partially offset by equity inflows. From the beginning of May the rand exchange rate depreciated from R8.90 against the USD to levels of R10.40 in August.

A number of central banks in emerging markets reacted quite differently to these movements, with some tightening monetary policy despite an evident slowdown in growth, others intervening in the foreign exchange market and others draining liquidity in local markets. The central bank of Brazil has since April this year, increased its policy rate by a total of 225 basis points to 9.5 per cent due to inflation pressures and to shore-up the currency and limit capital outflows, while also lifting previous taxes on capital inflows. The central bank in Indonesia increased the policy rate by 150 basis points thus far in 2013 to

7.25 per cent, but in emerging Europe we have seen various interest rate reductions.[1] The People's Bank of China (PBoC) reacted by initially tightening liquidity conditions, only to be relaxed soon thereafter to reverse a substantial increase in money-market rates and to resolve liquidity issues.

Although markets have retraced following the Fed's decision not to taper after all, it should be remembered that this is only a delay, and has helped to buy time for emerging markets to prepare as best as they can for when tapering actually takes place.

Emerging markets that defended their currencies during May and June of this year through the sale of foreign exchange reserves, have rebuilt these buffers, reflecting a resumption of significant capital flows into emerging markets. Countries such as Mexico, Turkey, Brazil, South Korea and Indonesia, have in the past two months erased losses in foreign exchange holdings that totalled about US$40 billion between April and July, according to data from JPMorgan. In addition, China appears to have added about US$163 billion in the third quarter, bringing its stock of reserves to a record US$3.66 trillion.[2] South Africa studied what other emerging markets were doing, but given its own particular circumstances deemed it not appropriate to tighten policy during that period, nor to implement any measures aimed at the foreign exchange market.

4. Outlook

Clearly, asset purchase tapering by the Fed has been put on hold for now, but this will surely commence at some point. Is there need for alarm over emerging markets in light of tapering and is the slowdown in emerging markets really that severe? The IMF's latest Global Financial Stability Report[3] (GFSR) poses the question of what would happen if flows reversed more sharply in emerging markets? The GFSR suggests that while emerging markets may have become more vulnerable, they are also in a much better position than prevailed at the time of the 2008 crisis. In the 12 weeks following the reversal of risk sentiment during May 2012, assets under management for emerging market fixed-income funds fell by 7.6 per cent (or US$19 billion), much smaller than in 2008, when assets under management fell by 36 per cent (or US$26 billion) during the first round of the asset sell-off in September–October 2008, although the impact on local currency bond yields was similar across the two episodes.

Emerging market countries have come a long way in the last two decades and are not as fragile today as they would have been in the past. Foreign exchange reserve levels are much higher; monetary policy has greater credibility and there is a better track record of managing inflation; while fiscal positions are healthier than in many advanced economies; and they are less vulnerable to sudden stops given that there are less dollar liabilities. Macro-economic fundamentals have also improved significantly and while emerging markets may be slowing, they remain the biggest contributors to global growth, and this may well be a correction to more sustainable levels of growth after period of somewhat spectacular growth.

But, as we witnessed at the time of tapering talk, emerging markets did react. Exchange rates weakened, yields on fixed income instruments spiked and the equity markets sold off. It is likely that there will be a further reaction when tapering eventually becomes a reality, and while some of the effects of tapering may already be priced into markets, we cannot be sure of how much is priced in and therefore how much still needs to be reflected in asset prices.

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1 Hungary and Poland (–175 basis points), Turkey (–150 basis points)

2 Emerging markets rebuild fx reserves after recent turmoil, Financial Times, 22 October 2013

3 www.imf.org, GFSR, October 2013

As I indicated earlier, South Africa's economic performance has lagged behind other emerging market economies through the crisis, and continues to reflect lacklustre growth. The Bank has repeatedly raised its inflation forecasts and lowered the growth forecasts since the end of 2012. The 2013 forecast for the CPI inflation was raised from 5.5 per cent in December 2012 to 5.9 per cent in September 2013, while the forecast for 2014 was raised from 5.0 per cent to 5.8 per cent over the same period. Real GDP forecasts for 2013 were lowered from 2.9 per cent at the end of 2012, to 2.0 per cent more recently, and for 2014 from 3.6 per cent to 3.3 per cent. The Bank's Monetary Policy Committee (MPC), faced with such an environment has found it prudent to keep the policy rate steady throughout 2013, as despite the rising trend in inflation, the MPC deemed inflationary pressures stemming from the demand side of the economy to be subdued, and therefore that inflation pressures largely related to supply shocks and the weaker exchange rate.

However, as noted in the most recent MPC statement, the upward drift in core inflation in the absence of any obvious demand pressures would suggest that there may be emerging underlying pressures owing to lagged effects of the exchange rate depreciation as well as higher unit labour costs. Although the rand has appreciated from the levels of R10.40 during August 2013, it remains vulnerable to changes in the global and domestic environment. Furthermore, while inflation expectations appear to be anchored and relatively stable, expectations are uncomfortably close to the upper end of the inflation target range.

Growth remains below potential with a widening output gap and is expected to average only 2.0 per cent in 2013 and 3.3 per cent in 2014. The leading indicator of the Bank suggests that the moderate growth rates are set to continue, while protracted work stoppages in the mining and manufacturing sectors are likely to detract from growth going forward. Consumer spending is also expected to remain modest, capped by high household debt levels, low employment creation and rising administered prices.

More recently, concerns over the current account deficit have heightened, and these concerns have been propelled by the fact that South Africa's terms of trade have deteriorated, exports have failed to react sufficiently to the weaker rand, and the global environment characterised for the best part of five years by easy liquidity, is in the process of transforming. Investors have shifted their focus to macroeconomic imbalances and have become increasingly concerned about countries with high current account and budget deficits, which rely heavily on international capital flows. Along with monetary policy slowly turning the corner in advanced economies, a fundamental reassessment of the emerging market investment case appears to be under way, as the recent impact of the announcement of the intentions of the Fed to soon embark on a withdrawal from unconventional monetary policy seems to have exposed vulnerabilities in certain countries that may have been underestimated previously.

Although the recent breach of the inflation target is expected to be temporary, and we recently saw CPI inflation decelerate from 6.4 per cent in August to 6.0 per cent in September, there are significant upside risks, not least of which relate to wages and the exchange rate. In line with its mandate, the Bank continues to monitor developments carefully. Indications that inflation will deteriorate significantly or remain outside of target for a protracted period and affect inflation expectations, will require the appropriate policy response from the MPC.

As we approach 2014, while there appears to be reason for optimism overall as the global recovery gathers momentum, we will have to contend with an environment that continues to be characterised by uncertainty and volatility. The extent of the impact of the exit from unconventional monetary policy measures remains unclear. Given the many uncertainties in the global environment that are beyond our control, there is little room to get wrong that which is within our control, such as focused, effective and efficient implementation of reforms and policies that will improve our competitiveness and enhance our attractiveness as an investment destination, labour representatives and employers taking full ownership and responsibility for restoring orderly industrial relations, and maintaining credible fiscal and monetary policies.

In closing, may I be the first to congratulate all of you who have been nominated for this year's awards. It is always gratifying and a special honour to have one's hard work, efforts and contribution in your profession appreciated and recognised by peers in this manner. We thank you for your inspiration and leadership and for serving as an example to many of us.

Thank you.