# Gill Marcus: The outlook for the South African economy in a challenging global environment

Address by Ms Gill Marcus, Governor of the South African Reserve Bank, to the Distinguished Speakers Seminar, European Economics and Financial Centre, London, 8 April 2014.

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Thank you for the opportunity to address you this afternoon. Today's discussion takes place at a time when the UK is one of the advanced economies that is showing signs of sustained recovery from the global financial crisis. This is good news not just for the UK, but also for South Africa, which still has strong trade and investment links with your country. However, after nearly seven grueling years, we need to recognise that the global financial crisis is not yet over. Rather, we have entered a new phase, one which is moving in the right direction, but one that is no less uncertain and risky than previous phases, and which poses new challenges for emerging economies in particular. The unwinding of the extraordinary monetary policy actions of the past by the US Fed is taking us all into unknown territory, and there is no history or precedent to guide us. Emerging economies had to deal with the spillover effects of monetary accommodation in the advanced economies, and the challenges to be faced by their reversal will be no less daunting. However, while the adjustment will be difficult, I believe that emerging economies in general, including South Africa, are more resilient and better equipped to respond to such challenges than was the case in the past.

One of the consequences of the unconventional monetary policies adopted in a number of the advanced economies in response to the global financial crisis was a significant change in the pattern of global capital flows. As the search for yield became more intense, emerging economies had to contend with large capital inflows. Although these flows presented opportunities, they also brought challenges in the form of appreciating exchange rates and lower interest rates, which had the potential to cause a buildup of macroeconomic imbalances, including, in some instances, excessive credit extension, asset price bubbles and widening fiscal and current account deficits. The appreciating currencies also made the products of these economies less competitive, with significant consequences for domestic manufacturing, for instance.

The announcement by the US Fed in May last year that a reduction of asset purchases was likely to commence at some stage later in the year had a marked impact on these global capital flows, amid initial uncertainty about the timing and quantum of the tapering. The widely expected commencement of tapering in September did not occur, and markets overscrutinised every bit of data coming out of the US for possible indications of the start of the process. An extremely volatile period of "risk on" and "risk off" episodes ensued, particularly for those countries that had been the previous beneficiaries of the capital inflows. Indications of slowing employment growth in the US were seen as good news for emerging markets, as it implied a delay of either tapering or normalisation. As a result, emerging market exchange rates, including the rand, experienced a high degree of volatility in the face of these changing flows. As shown in a recent paper by Eichengreen and Gupta, the countries most affected were those with large current account deficits and those with relatively large and liquid financial markets which allowed for investors to be better able to rebalance their portfolios. The issue was further complicated by the fact that the markets initially conflated tapering, which related to the slowdown of Fed asset purchases, with monetary policy tightening or normalisation of short-term policy rates.

It appears now that the financial markets generally accept that tapering by the US Fed will proceed at a steady pace. However, the next phase of normalisation, that of the timing and extent of the US policy rate cycle, is now the subject of intense speculation. Already we have seen the market reaction to the Fed statements following the most recent FOMC meeting,

when there were indications that the timing of the first policy rate adjustment may occur sooner than previously believed.

There is little doubt that this process will not proceed in a linear fashion: the outlook for the coming interest rate cycle is likely to keep changing and be affected by the ebbs and flows of data coming out of the US. The outlook may also be complicated by the monetary policy exit strategies of the UK, Japan and the ongoing challenges faced by the Eurozone. While emerging markets, including South Africa, are likely to experience periods of relative stability, as is the case at the moment, we do expect volatile periods ahead. Thus while a sustained recovery in the US is critical to ending the global financial crisis, and is good news, in the short run it introduces increased risks and volatility with consequences for growth, capital outflows, commodity prices, exchange rate depreciation and inflation in many emerging markets.

But this volatile global financial market environment is not the only challenge facing us. The possibility of a slowdown in China poses further risks, not only to the growth recovery in the advanced economies, but also to emerging markets in general. Trade and investment linkages with China have increased markedly in recent years, and a slowdown could adversely affect these trends. An important channel of transmission of a slowdown is already being felt by commodity exporters through the impact on commodity prices, particularly industrial commodities. The nature of the reaction function of the Chinese authorities and possible stimulus packages is still uncertain. Complicating the outlook are the challenges faced by the Chinese banking sector, in particular the shadow banking sector, which has the potential to reinforce the slowdown.

More positively, the outlook for the advanced economies appears to be improving, but already some doubts have arisen regarding the strength of the recovery following a generally disappointing first quarter. From a South African perspective, although the recovery in the UK appears to be sustained, we are particularly concerned about the slow pace of recovery in the rest of Europe, which remains an important destination for our manufactured exports. The outlook for emerging markets, by contrast, has deteriorated in recent months, and there is a risk that a generalised slowdown in these economies could undermine the recovery in the advanced economies.

How has South Africa fared against this challenging backdrop? Following the initial announcement by the US Fed regarding possible tapering, the rand was one of the currencies most negatively affected. The rand was at around R9,00 against the US dollar at the beginning of May 2013, and depreciated to around R10,00 against the dollar following the initial tapering announcement. It then followed a volatile depreciating trend, reaching its weakest point of R11,39 against the dollar immediately after the January MPC meeting. Since then it has followed an appreciating, but volatile trend, to reach a recent high of around R10,50 in early April. We expect this pattern of volatility to continue, as the hesitant move towards US monetary policy normalisation proceeds, with markets being overly sensitive to any data coming out of the US. For example, last week's non-farm payrolls data came in slightly lower than expected. This disappointing news for the US was seen as good news for emerging markets, and the rand, along with the Brazilian real, appreciated by over one per cent in response.

Underlying these volatile movements in the exchange rate was the changing pattern of capital flows. During 2012, net purchases of South African government bonds by non-residents totaled R88,6 bn, influenced in part by South Africa's inclusion in the Citibank World Government Bond Index during the year. These flows became more volatile during 2013, in line with the on-off nature of the move towards tapering. As the markets became more certain that tapering would begin, portfolio outflows proceeded at a significant rate. Between November 2013 and January 2014, net sales of bonds by non-residents amounted to R46 bn while net equity sales amounted to R25 bn. Since then, however, the outflows have abated, and in February and March net purchases of equities to the value of R13,3 bn

were recorded, alongside a small net inflow into the bond market of R250 m. While to date the current account deficit has been adequately financed through other forms of capital inflows and without recourse to selling reserves, it could create a challenge going forward.

However, the rand has also been affected by a number of other idiosyncratic and global factors. These include a series of protracted strikes in the motor vehicle and mining sectors in particular; a decline in the terms of trade of just over 4 per cent in 2012 and 2013, largely in response to the slowdown in China; and a widening of the deficit on the current account of the balance of payments, which, in conjunction with the fiscal deficit of around 4 per cent of GDP is seen to have contributed to the vulnerability of the economy to the possibility of a sudden stop in capital flows. The current account deficit widened from 2,3 per cent of GDP in 2011 to 5,8 in 2013, with the trade account accounting for about half of this number.

This deterioration has occurred despite the significant depreciation of the nominal effective exchange rate of the rand of over 22 per cent since the beginning of 2012. Apart from the usual adjustment lags and J-curve effects there are a number of factors that could explain the slow response. First, to the extent that the depreciation is an adjustment to the declining terms of trade, it is cushioning the mining sector, rather than being a stimulus to further output and investment. Second, the pass-through to consumer prices has been relatively constrained to date, and ironically this impedes the adjustment process as the required relative price changes have not taken place. While this muted pass-through does help to ensure that the depreciation is real, the competitive advantage of manufacturers has been eroded by sharp increases in a number of key inputs in recent years, particularly electricity. Third, our traditional trading partner countries, particularly in Europe, are still experiencing slow growth. While Africa has now overtaken Europe as the main destination for our manufacturing exports, the capacity of these countries to import could also be negatively affected by the reversal of capital flows and declining commodity prices.

Fourth, protracted domestic labour disputes have impeded output and exports in the manufacturing and mining sectors, while at the same time uncertainty regarding proposed mining legislation had dampened new investment in this sector. In addition, structural infrastructural constraints, particularly relating to electricity supplies as well as transport, have negatively affected our ability to get goods to, and out of, the ports. Finally, there is the relatively inelastic nature of import demand with respect to capital equipment for the ongoing much-needed infrastructure expenditure, which we must not cut back on.

There are tentative signs that we may have reached the turning point with respect to the adjustment process. The current account deficit narrowed to 5,1 per cent of GDP in the final quarter of 2013, down from 6,4 per cent in the previous quarter, and although the trade deficit widened further in January to R16,9 bn, February saw a surplus of R1,7 bn, following a R6,1 bn increase in the value of exports, and a R12,5 bn decline in imports. Net exports made positive contributions to GDP growth in both the third and fourth quarters of 2013, contributing 1,6 and 7,8 percentage points in these two quarters respectively. The fourth quarter outcome was the highest contribution to quarterly growth since the final quarter of 2007, and although net exports were still a drag on annual growth in 2013 at –0,5 percentage points, this was significantly lower than the –1,7 percentage points recorded in 2012. Furthermore, the Bureau for Economic Research's indicators for manufactured export sales and orders rose to its highest level in 10 years in the first quarter of this year. At the same time, declining new motor vehicle sales, amid weakening consumer demand, could contribute to a reduction in imports. There has also been a response on the services account where tourism receipts have increased markedly, and we expect this trend to continue. So despite the ongoing challenges to platinum exports, we are cautiously optimistic that we may be seeing a sustained improvement in the current account.

While the exchange rate has been an important shock absorber for the South African economy, some concern has been expressed regarding its volatility. We have not attempted to intervene directly in the foreign exchange market as we do not believe that such

intervention would be effective, given the size of South Africa's foreign exchange market, and our relatively low level of foreign exchange reserves of around US$50 billion. Fortunately we do not suffer some of the negative balance sheet effects that have led to a "fear of floating" in a number of emerging economies: we do not have significant currency mismatches and our corporates, banks, households and government have relatively small net foreign currency exposures. However, volatility does make it difficult to plan and make long term investment decisions. From a monetary policy perspective, our focus is not to try and influence the exchange rate, but rather to focus on preventing the second round effects of the depreciation from impacting on the overall inflation rate. As I will touch on later, the exchange rate has had an impact on inflation, and remains a significant risk to the inflation outlook.

South Africa's growth performance in the post-crisis period has been disappointing, having averaged 2,8 per cent since 2010. This can be attributed in part to the slow recovery in our major trading partners. In 2013, growth averaged 1,9 per cent, well below potential growth currently estimated to be between 3,0 and 3,5 per cent. The Bank's forecast for growth in 2014 and 2015 is 2,6 per cent and 3,1 per cent for these two years respectively. While this is an improvement, it is still below potential, and likely to have a minimal positive impact on the unemployment rate, which currently stands at 24,1 per cent. Employment growth has been slow, and what growth there has been has mainly been in the public sector. For example, in the year to the fourth quarter of 2013, non-agricultural formal sector employment grew by 0,5 per cent or about 41,000 jobs, of which 39,000 were in the public sector.

The constraints to growth are mainly structural in nature, but in the near term there are two main risks to the growth outlook. The first is the uncertainty of electricity supply. South Africa's electricity supply has been constrained for some time, and has no doubt impacted on investment decisions in the economy. The current tight conditions on the grid are likely to be stretched going into winter, imparting a near-term downside risk to our growth outlook. However, this constraint should be relieved during 2015 due to a significant new power plant build programme that has been in place over the past few years. New capacity is expected to come on stream late in 2014, and as this gets added to the grid, the shortage should ease.

A further challenge arises from the protracted strike in the platinum sector, which is now in its 12th week, with no resolution in sight. To date exports have been temporarily cushioned by the depletion of stockpiles, but it will affect the GDP growth outcome. Whether or not this strike has longer term ramifications will depend on its persistence, the nature of the ultimate settlement, and any knock-on effect on other sectors and wage settlements. However, the dispute is indicative of an urgent need to address industrial relations not only in the mining sector but in the broader economy, and requires a change in mindset from both workers and employers. We are hopeful that an acceptable settlement can be achieved soon that satisfies all parties. But in the meantime the cost to workers, financially and in terms of human suffering, and to the mining companies is enormous.

There are also a number of positive developments, in addition to the significant infrastructure build programme that is already well advanced, that will underpin growth in the longer term. Last year parliament unanimously adopted the National Development Plan as the long term vision for growth and employment creation. While this is not a rigid blueprint, it provides a framework which, if largely implemented, should change the South African economy fundamentally. The key points in the NDP are to promote faster and more inclusive economic growth, to build a capable state, to promote good governance and an active citizenry and to promote collaborative partnerships across society, including between government and business.

The key economic policy recommendations are to promote exports, raise competitiveness, lower the cost of living for the poor, improve skills development and improve the functioning of the labour market. Critical actions required for faster economic growth include investing in economic infrastructure to lift the potential growth of the economy and removing regulatory barriers to newer firms to promote easier entry and greater competitiveness.

South Africa has already made significant strides in improving the lives of millions of people. Without going into too much detail, a report released by Stats SA last week showed that poverty levels in the country have dropped from 57,2 per cent in 2006 to 45,5 per cent in 2011. As of 2011, 32,3 per cent of the population were living below the National Planning Commission's lower bound poverty line, compared with 42,2 per cent in 2006. The Gini coefficient, which reflects income inequalities remains high but declined from 0,72 to 0,69.

The focus on economic infrastructure expenditure in the NDP is key. The recent government budget provides for capital expenditure by the major state-owned companies of almost R400 billon to be spent on infrastructure during the coming three years, the bulk of this on electricity and transport infrastructure. This should have a positive impact not only on current growth during the build phases, but also on future growth as infrastructure bottlenecks are eased. The investment outlook from the government and state-owned enterprises therefore looks positive, and should help with the crowding in of private sector investment. We are also seeing favourable signs in the construction sector, particularly in civil construction.

The outlook for private sector fixed investment is also more positive, despite relatively low levels of business confidence. Having been relatively subdued during the past few years, growth in gross fixed capital formation by the private sector increased from 3,9 per cent in 2012 to 5,5 per cent in 2013. Part of this increase was related to green energy investment. This indicates that if the near-term constraints can be eased and business confidence improves, there is scope for further growth in fixed investment, and this could allow for a rotation away from consumption expenditure towards investment as the main driver of growth. In 2013, the contribution of consumption expenditure to GDP growth had declined to 1,7 percentage point, compared with 2,3 in the 2012, while the contribution of gross fixed capital formation was unchanged at 0,9 percentage points.

In contrast to the mining sector, the manufacturing sector also shows tentative signs of having turned the corner following particular strike-related challenges during 2013, particularly in the motor vehicle sector. The manufacturing PMI had been below the neutral level of 50 index points for the second half of 2013 and early 2014, has now returned to above 50. We are hopeful that these green shoots will lead to a sustained recovery in the sector amid a recovery in motor vehicle exports in particular.

There are also significant opportunities for South Africa at the regional level. According to the latest World Economic Outlook, economic growth in sub-Saharan Africa is expected to average 6,1 per cent in 2014 and 5,8 per cent in 2015. As I noted earlier, there has been a significant shift in South Africa's 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, was felt particularly hard in the motor vehicle export sector. However the decline in vehicle 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. There is enormous potential for regional infrastructure development which will enhance the growth potential of South Africa and its neighbours.

The current environment has created a difficult context for monetary policy. For some time now the Monetary Policy Committee has had to face the dilemma of a relatively subdued growth environment and a rising trend in inflation. Apart from a temporary breach of the target in July and August 2013, inflation has remained within the target range since early 2012, and the repurchase rate had been unchanged at 5,0 per cent since July 2012. Notwithstanding the unusually low level of pass-through to inflation, the exchange rate has

posed the biggest upside risk to the inflation outlook. Adverse exchange rate and food price developments resulted in a deterioration of the inflation outlook in January 2014 when the forecast suggested that inflation was likely to breach the upper end of the band during the second quarter of 2014, and to peak at an average of 6,6 per cent in the final quarter of the year. Inflation was expected to average 6,0 per cent in the second quarter of 2015 and remain close to the top of the band for the remainder of the year.

With the risks to the inflation outlook seen to be on the upside, this trajectory suggested the need for some monetary policy tightening. However, the difficulty facing the MPC was the slow pace of economic growth, the lack of clear demand pressures as seen in the tepid growth in consumption expenditure by households, amid subdued growth in credit extension. In the event, the MPC decided that it would be appropriate to embark on a moderate tightening cycle, starting with a 50 basis point increase of the repurchase rate in January. It was indicated that the speed and intensity of the cycle would be dependent on unfolding data, and would be consistent with our flexible inflation targeting framework. At the most recent meeting in March, the inflation forecast had improved slightly, particularly for 2015, and the MPC kept the repurchase rate unchanged. Nevertheless we re-emphasised that we are in a moderate tightening cycle, but that it does not necessarily mean that rates will be changed at every meeting or by the same amount. An important consideration for the MPC was that failure to react could have an adverse impact on inflation expectations which until now have been relatively stable and anchored, albeit at the upper end of the target range.

Despite the increase in the repo rate in January, the real policy rate is still slightly negative, and well below what could be considered the neutral rate. While such an accommodative stance has been considered appropriate given the developments in the real economy, pressures from the exchange rate and capital flows, and the possible normalisation of monetary policy in the US imply that this stance cannot be maintained indefinitely. At this stage we do not have a clear view of what the longer term post-crisis “new normal” neutral interest rate will be, either in South Africa or at a global level. This is a subject of debate in most countries. We do know that some adjustment will be required, but the nature of the adjustment needs to be sensitive to the context that we find ourselves in. And the context will determine how pre-emptive or reactive we will be.

This does not mean that we blindly follow US monetary policy. The impact of Fed tapering and associated capital outflows has been felt on the long term bond yields, which at one stage had increased by about 200 basis points, but have since moderated somewhat. This is not surprising, as tapering has more to do with the long end of the yield curve than the short end. Central banks can indirectly influence long term rates, but do not have the same direct control over them as they do with short term rates.

As noted in a recent article in the FT by Charles Goodhart, long-term interest rates are more correlated across countries than short-term rates, and countries with flexible exchange rates are more able to set policy rates independently of the Fed funds rate. However, this independence is not complete. Exchange rate pressures may lead to inflation pressure that may require a monetary policy response. But this partial independence does mean that short term rates can be more related to domestic cyclical considerations.

In conclusion, South Africa, along with many of its emerging market peers, is facing a challenging period ahead. We are facing a difficult global context, which will have significant and uncertain spillover effects on us. While the advanced economies will pay lip-service to mitigating these effects, the reality is that they are likely to conduct their policies with domestic consideration in mind. South Africa also faces a number of domestic challenges. The solutions are there, but we need the community of purpose to implement these initiatives. Education and infrastructure are key elements in the much needed structural reform agenda, but this investment takes time and there is no quick fix. It is going to be a difficult road ahead, but it needs to be done and can be done. Monetary policy will play its role, but it cannot solve the underlying structural problems. We will continue to ensure a

stable macroeconomic environment and a well-regulated financial sector, within a flexible inflation targeting environment.

Thank you.