Gill Marcus: Overview of the South African economy

Address by Ms Gill Marcus, Governor of the South African Reserve Bank, at the 94th annual ordinary general meeting of shareholders, Pretoria, 25 July 2014.

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Governor's address

Dear Shareholders,

Members of the Board,

Deputy Governors,

Ladies and Gentlemen,

The past year has been no less challenging for South Africa than any of the previous years since the start of the global financial crisis, which is now in its seventh year. The slow and uneven global recovery has continued, with the United Kingdom (UK) showing the most sustained signs of recovery among the advanced economies. The earlier optimism that the US economy had finally turned the corner, following fiscal challenges in 2013, was tempered following the GDP growth contraction of 2,9 per cent in the first quarter of this year. While part of this can be attributed to adverse weather conditions, there are conflicting signals coming out of the US. Corporate balance sheets appear to be healthy, and the labour market is improving, with the unemployment rate having declined to 6,1 per cent in June 2014 from 7,5 per cent a year ago. However, the housing market has weakened recently, possibly in response to higher long term rates and the economy remains vulnerable to higher interest rates. The earlier expectation of growth of around 3 per cent appears to be out of reach for 2014, and the expectation is now closer to 2 per cent.

The Eurozone emerged from recession in the early part of 2014, but slow growth is expected to persist amid tight lending criteria by banks and strong fiscal consolidation in a number of countries, particularly in the periphery. More recently France, Germany and Italy, the largest economies in the region, have shown signs of slowing and growth forecasts have been revised downwards. The risk of deflation in the Eurozone persists, and remains a particular concern to the ECB, which recently announced a further round of unconventional policy stimulus. Uncertainty still surrounds the sustainability of the response of the Japanese economy to the fiscal and monetary policy stimuli implemented during the past year. Household consumption expenditure surged in the first quarter in anticipation of consumption tax increases, resulting in a strong GDP growth performance in the quarter. Second quarter growth is expected to be negative as the higher taxes take effect.

The past year has also seen slowing growth in a number of the larger emerging market economies. This followed a slowdown in China and a reversal of capital flows to emerging markets in the wake of indications that the US Federal Reserve (the Fed) would taper its bond-buying programme. Growth in China has been negatively impacted by concerns about the shadow banking system, the overheating housing market and tightening credit conditions. Its growth is now expected to be below 7,5 per cent, lower than historically, and while risks are seen to be on the downside recent data suggest that these downside risks may have dissipated somewhat. The South African growth prospects are sensitive to developments in China through the impact of slower Chinese growth on commodity prices. Latin American countries, particularly Brazil, have also felt the slowdown. Other larger emerging markets that have experienced weaker growth include Indonesia, Russia, Thailand and Turkey, while India has recently shown some signs of recovery.

Global financial markets have been dominated by changing assessments of the outlook for US monetary policy. As the US growth outlook improved, the Fed hinted in May last year that it was considering reducing the amount of stimulus granted in the form of quantitative easing, which involves purchases of bonds by the Fed from the market. This created considerable uncertainty regarding the timing and speed of this tapering, and expectations in this regard kept changing in response to changing data coming out of the US. These developments impacted on emerging markets which generally experienced capital outflows and volatile exchange rates in response to changing risk perceptions. By the beginning of February of 2014, once orderly tapering was priced into the market, the focus moved to the timing and speed of interest rate normalisation.

More recently, as growth prospects in the US deteriorated, consensus forecasts and guidance from the US Fed appeared to shift the expected timing of the first interest rate increase further out into the future, with a slower pace of increase. The forward guidance provided by the central banks in the advanced economies has contributed to a low level of financial market volatility, and there are concerns that this could encourage excessive risk taking and asset price bubbles. Speculation regarding the timing of US interest rate normalisation is likely to remain a source of volatility and dominate financial markets for some time to come. It is also complicated by the fact that normalisation in the advanced economies is likely to be unsynchronised, with further loosening expected in Japan and the Eurozone, while the Bank of England has indicated that the first policy rate increase could already occur later this year, but at a moderate pace.

Over the period under review, the South African economy faced a very challenging environment against this global backdrop, with domestic issues compounding these difficulties. The exchange rate moved broadly in line with a number of emerging-market economies in response to tapering and capital-flow reversals. For example, between the beginning of November 2013 and the beginning of February 2014, net sales of bonds and equities by non-residents totalled just over R70 bn, but since then net purchases have totalled over R40 bn. The rand has generally depreciated over the period, although with a high degree of volatility in response to these wide swings in capital flows. However, idiosyncratic factors caused the rand to diverge from its emerging market peers at times. In particular, the rand was also influenced by the widening deficit on the current account of the balance of payments, and by a succession of protracted labour disputes in the motor-vehicle subsector and mining sectors in particular, which have undermined the country’s export and growth performance and prospects.

The fraught labour relations environment contributed to the decline in domestic economic growth from 2,5 per cent in 2012 to 1,9 per cent in 2013, and the economy contracted by 0,6 per cent in the first quarter of 2014. While the monthly data for April pointed to a better second quarter outcome, both mining and manufacturing outcomes in May were again negative. With household consumption expenditure and private sector investment growth expected to slow further amid weak business confidence, the Bank has lowered its growth forecast for 2014 to 1,7 per cent. Under these circumstances, the high level of unemployment, currently at around 25 per cent, is expected to persist and employment growth is expected to remain constrained, particularly in the private sector. The need for fiscal consolidation is also likely to constrain public sector employment growth, which to date has been the main driver of employment growth since the onset of the crisis.

The environment for monetary policy became increasingly complex under these conditions, with the inflation outlook deteriorating as the economy weakened. Inflation breached the upper end of the target band in July and August 2013, but as the breach was anticipated to be temporary, monetary policy did not react to it. However, in January 2014, further pressures from the exchange rate and food prices saw a significant upward revision of the inflation forecast: inflation was expected to breach the upper end of the band for an extended period of about four quarters from the second quarter of 2014 and to peak at around 6,6 per cent in the fourth quarter of 2014. In line with this forecast, inflation measured 6,1 per cent in April 2014, and 6,6 per cent in both May and June, resulting in a second quarter CPI average of 6,4 per cent.

The most recent forecast of the Bank shows that inflation is expected to average 6,3 per cent in 2014, with the quarterly peak of 6,6 per cent still expected in the fourth quarter, following a slight moderation in the third quarter. The forecast average inflation for 2015 and 2016 is 5,9 per cent and 5,6 per cent respectively, with inflation expected to average 5,5 per cent in the final quarter of 2016. Inflation is expected to return to within the target band during the second quarter of 2015.

Monetary policy therefore faced a difficult dilemma in the period under review, with a widening output gap, downside risks to growth, and a deteriorating inflation profile with upside risks. In response to these inflation developments and in light of the need for monetary policy normalisation over time, the Bank's Monetary Policy Committee (MPC) decided at its meeting in January 2014 to embark on a moderate tightening cycle and raised the repurchase (repo) rate by 50 basis points to 5,5 per cent per annum.

As the growth outlook deteriorated further and the inflation risks moderated slightly, the monetary policy stance remained unchanged at the MPC's subsequent meetings in March and May. However, in the July meeting, the MPC decided to continue on its gradual normalisation path, and raised the repurchase rate by 25 basis points to 5,75 per cent per annum. The Committee remained concerned about the upside risks to the inflation outlook, and the increased risk of a wage-price spiral in the context of the current difficult labour relations environment, with the risk of double digit wage settlements becoming the economy-wide norm.

Given the global and domestic risks to the outlook, future changes in the monetary policy stance will remain highly data-dependent. The MPC will remain focused on its core mandate of price stability, but will also be mindful of the impact of its policy actions on economic growth. Many of the problems that the country faces are not within the purview of the Bank's mandate, nor does the Bank have the policy levers to address these issues. However, the Bank will continue to play its part in supporting the economy through these difficult times by maintaining its focus on price stability in support of sustainable economic growth.

While price stability remains the core mandate of the Bank, financial stability has become part of its extended mandate, which is being formalised in the draft Financial Sector Regulation Bill of 2013. The revised Bill is expected to be tabled in Parliament later this year. Planning for the implementation of the Twin Peaks Regulatory Model is proceeding. This model locates the regulation and supervision of both banks and insurance companies within the Bank and allocates market-conduct oversight to a new authority that will replace the Financial Services Board (FSB). The envisaged changes will have a significant impact on the Bank in terms of responsibilities and resources, with a sizeable increase in personnel expected.

Although we have to wait until the legislation is passed to give full effect to the envisaged changes, we have still paid attention to our financial stability responsibilities: the Bank Supervision Department (BSD) has increased its supervisory vigilance domestically and its role on the Basel Committee on Banking Supervision (BCBS); the Bank's Financial Stability Committee (FSC) meets regularly and work is being done to develop a macro-prudential policy toolkit. This is unchartered territory and a challenge faced by most countries. Fortunately, our banks and the financial system in general have remained stable, despite the difficult global and domestic environments.

Let me now turn to the Annual Report

The financial statements presented to you today show that the Bank has again recorded a loss. As I explained in some detail in my address to shareholders last year, the Bank is not driven by a profit motive, but rather acts in the best interests of the country. The Group recorded an after-tax loss of R1,6 billion in the year under review, compared with the R1,3 billion loss in the previous financial year. Once again, the major source of our losses emanated from the holding of foreign exchange reserves. Net interest income earned on the country's foreign-exchange reserves remained constrained by low global interest rates as monetary policy in the advanced economies remained highly accommodative. At the same time, costs increased, including those associated with the introduction of the new currency in 2012 which were carried over into the following financial year, and staffing costs which rose as a result of salary increases and additional appointments required due to the expanded operations of the Bank. Although the losses recorded arose from the Bank performing its functions in the interest of the economy, we remain committed to containing costs and maximising operational efficiency, and are confident that the Bank will return to profitability over the next few years.

Acting on legal advice, the Bank has embarked on a formal process to regularise shareholding in the Bank. This entailed addressing correspondence to all shareholders of the Bank who hold shares in contravention of section 22 of the SARB Act. These shareholders hold, together with their associates, more than 10 000 shares in the Bank, without having made the prescribed disclosure as required by law. These shareholders were called upon to provide the Bank with an irrevocable undertaking that they would dispose of the number of shares in the Bank as may be necessary to ensure that they, together with their associates, would in aggregate hold no more than 10 000 shares. Shareholders were advised that should they fail and/or refuse to provide the required undertaking and fail to dispose of the requisite shares in the Bank, legal proceedings against them in terms of section 22 of the SARB Act would be instituted for an appropriate order to redress the matter. This order may include the disposal of shares in the Bank at a price per share and subject to such terms, conditions and restrictions as a Court may determine.

This year the shareholder road show was only held in Pretoria on 9 July. As attendance in other centres has been poor in recent years, we had indicated that the meeting would be broadcast live to the Cape Town and Durban branches via video conferencing. However, as we did not receive any responses from shareholders confirming their attendance at these venues, the broadcast was cancelled. The Pretoria road show was well attended and I encourage shareholders to take this opportunity in future to interact with the executive of the Bank, outside of the AGM.

Once again, the questions posed at the road show were specific to the persons attending. However, it would be opportune at this time to highlight that during the financial year 2013/14 the Group adopted new accounting standards and reclassified certain financial information. This has resulted in the comparatives being restated for the financial years ending 2012 and 2013, and therefore the need for restated statements of the financial position and profit and loss. I refer you to note 16 in the *2013/14 Annual* Report for further details in this regard.

You have been advised that this year the Panel selected only one candidate each for the non-executive director vacancies in the mining and labour sectors. This was due to the fact that very few nominations were received from the public in these sectors. The Bank will review how it can improve the profile of the request for nominations to ensure a greater public awareness of the process going forward.