Gill Marcus: Outlook for the South African economy against the background of global economic developments

Address by Ms Gill Marcus, Governor of the South African Reserve Bank, at the Dinner in Honour of Ambassadors and High Commissioners to the Republic of South Africa, Pretoria, 2 October 2014.

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Your Excellencies, Ambassadors, High Commissioners, Counsels and Diplomats, good evening. Thank you for kindly accepting our invitation to this dinner, which is becoming a firm feature of the annual diplomatic calendar. We live in an interconnected world, and the lessons of the past few years show the need for cooperation and collaboration. The global financial crisis impacted in some way on most economies, and we are still feeling the effects as the recovery continues in a hesitant manner. And the nature of the recovery in smaller economies such as South Africa is shaped, to an important degree, by the speed and nature of the recovery in advanced economies. This evening I will give a brief overview of how we see the global economy evolving and then focus on the outlook for the South African economy in the challenging global and domestic context.

For some regions in the world, the past year has been better than the previous one, though the recovery is far from assured or complete. The United States is projected to grow strongly, especially in the second half of this year. After gaining momentum for several quarters, Japan’s growth seems to have faltered. China has been able to maintain growth above 7 per cent despite a significant economic and political transition. The UK economy is accelerating, with unemployment rates continuing to fall. Growth has improved in India, buoyed by a new optimism since the elections. Despite lower commodity prices, growth on the African continent remains robust. Most emerging markets have weathered the turbulence caused first by “taper talk” and then by actual tapering, which is likely to conclude this month. The Eurozone is the key exception. Peripheral Europe is experiencing positive growth, albeit at a low level. The Germany economy, however, contracted in the second quarter while growth in France remained at around zero. The Eurozone remains a significant market for South African exports. Low European inflation and the risk of deflation point to weak potential GDP growth with structurally weak demand across the monetary union.

After a period of relative calm in financial markets, volatility has increased recently, with the key trends being the strength of the US dollar, a weakening Euro and lower commodity prices. Considerable risks and imbalances in the global economy remain and policy makers have to remain vigilant.

It is highly likely that, after a long period of a synchronised downturn in the economic performance of advanced economies, next year will be characterised by an asynchronised recovery. The US economy appears to be in the advanced stages of repair with a declining degree of slack in the labour market. While there is uncertainty about the pace at which discouraged jobseekers will return to work, there is optimism that wage and income growth will return in the course of the next year. US corporate investment is rising and the fiscal metrics look better than last year. The UK is in a similar situation, perhaps even more advanced in their recovery, evident in falling unemployment and rising productivity. It is quite likely that these two economies will begin tightening monetary policy in the first half of 2015 and while the rates normalisation process is likely to be gradual and prolonged, given continued fragility in the global economy, interest rates are likely to be on their way up.

The monetary policy situation in the Eurozone is vastly different. Persistently low inflation threatens to unhinge long term inflation expectations, increasing the likelihood of deflation. Europe’s leaders recognise that higher inflation, on average, is critical to enable the economic adjustment process in peripheral Europe to continue. Last month the ECB reduced their key policy rate to 0.05 per cent and took their bank deposit rate further into negative territory. A commitment to purchase asset-backed securities from the commercial banks, designed to stimulate bank lending, was also announced. Furthermore, the ECB made it clear that if these measures did not work, they would consider more generalised quantitative easing, including the purchase of government bonds.

Even though Japanese inflation is at a five year high, long term inflation expectations in Japan remain low and hence policy makers are unlikely to withdraw the current monetary policy stimulus.

There is rising confidence that China's transition away from investment and exports towards domestic consumption will be managed smoothly. Risks in the housing market and related risks in the shadow banking sector remain a concern but, to date, the authorities have managed the adjustment without significant negative shocks. China's adjustment process does have a dampening effect on commodity prices, which impacts many emerging markets including those in sub-Saharan Africa. However, the possibility of higher Chinese consumption could provide a boost for the world economy over the longer term.

Foreign investment on the African continent is diversifying towards sectors outside of mining and oil. Investment in infrastructure, housing, retail, banking, telecoms and tourism continues to accelerate, sustaining growth rates in most sub-Saharan African countries.

In the year ahead global financial market conditions, in other words global liquidity, are likely to become more challenging. This should, however, be offset by improving growth prospects in the real economy. Countries with sound fiscal and monetary positions and those with higher savings rates are likely to benefit from this complex interplay of rising interest rates and improving economic performance in advanced economies.

In this complex milieu, South Africa's economic performance is disappointing. Projected GDP growth of 1.5 per cent this year will mark the fourth consecutive year of slowing growth. Global factors, in particular falling commodity prices and declining global liquidity, are contributing to our below par performance. Furthermore, lower demand for commodities from China and slow growth in Europe, our major trading partner, have affected our export performance. However, in the main, the reasons for our slow growth are domestic.

The five month-long strike in the platinum sector, followed by a month-long strike in the iron and steel industry, resulted in negative spill-over effects for the entire economy. These two strikes reduced manufacturing output and depressed household consumption, which negatively impacted on the performance of retailers, contributing to the downward revision to our growth forecast. Strikes are not usually a macroeconomic issue. They tend to occur every few years and are generally settled peacefully and speedily. But in the past two years strikes appear to be longer and more violent, with an apparent breakdown in the tried and tested dispute resolution processes contained in our labour relations regime. Without assigning blame to any party for this breakdown, a fraught labour relations environment cannot be consistent with policies aimed at growing labour intensive sectors of the economy.

Of particular concern are high salary settlements that are out of kilter with inflation and productivity growth. Firms often adjust to such salary increases by reducing staff numbers. About 48 000 jobs have been shed in the mining sector in the past two years and more mining companies have announced plans to reduce staff numbers. Similarly, in the past few months, the media have reported on planned retrenchments by MTN, Telkom and Ellerines. In a country with an unemployment rate of 25.5 percent, this trend has to be of concern to policy makers.

The second immediate constraint on the economy has been electricity supply. Electricity production has been flat for almost six years. While energy efficiency has enabled many firms and households to continue operating with less electricity, many sectors of the economy have had to curb production. Affected sectors include construction, mineral beneficiation and manufacturing. While South Africa has successfully brought about 160 mW of renewable energy into the grid, this boost is too small to make a difference to the aggregate capacity. The National Treasury estimates that electricity shortages have cost the economy about half a percentage point of growth a year, with this figure possibly being higher in 2014.

These two features, labour disputes and electricity shortages, have contributed to low levels of business confidence and investment, both of which are impacted upon by perceived policy uncertainty, particularly in areas such as mining and agriculture. Firms are reluctant to invest because they are uncertain about future demand and labour and energy costs. In turn, consumer demand is weak because firms are not investing and employment is not growing. Generally, governments break this cycle through higher public investment spending. South Africa is in the midst of a major public investment programme, focused largely on energy and freight logistics capacity. Despite positive growth in public investment, it has not been sufficient either to crowd in private investment or to lift the aggregate employment picture. In the 2nd quarter of 2014, private sector investment growth was negative for the first time since 2009.

At the same time as the economy has been performing poorly the central bank has had to contend with rising inflation. Inflation was above our target range of 3 to 6 per cent for one quarter in 2013 and has been outside the range since March this year. This combination of slowing growth and rising inflation is a difficult one for central banks to manage. The picture is complicated by the fact that normally, when growth slows, imports slow, reducing the current account deficit. This time, despite slower growth, imports remain sticky. And despite an exchange rate depreciation of almost 40 per cent since 2012, export performance has remained weak. This implies that South Africa still has a large foreign financing requirement at a time when global interest rates are rising and confidence in the domestic economy is sub-optimal.

Theories as to why exports have not done better given the weaker exchange rate range from poor European growth and slower demand from China to more fundamental competitiveness and structural problems in the South African economy. The reality is that both weaker growth in our key markets and faltering competitiveness in key export sectors are impacting on South African exports.

The main driver of higher inflation has been the effects of currency depreciation, which in turn is due to lower commodity prices and changing monetary conditions. Secondly, higher food prices have contributed to higher inflation in 2014. While the pass through from the weaker exchange rate into generalised inflation has been more muted than in previous episodes of depreciation, there is evidence of second round effects and the Bank has expressed its concern about rising salary expectations and a wage-price spiral.

The Bank raised interest rates by 50 basis points in January this year and by 25 basis points in July. Notwithstanding these increases, the policy interest rate remains close to zero in real terms. Monetary policy remains accommodative, cognisant of the weak real economy.

Going forward, it is possible that inflation will return to within the target range in the first quarter of 2015, but is likely to remain close to the top of the band. Also of concern is that core inflation is rising towards the top of the target range. Upside risks to inflation include higher electricity prices, rising wages and further depreciation of the exchange rate, which could be sensitive to changes in US interest rates.

The Bank has repeated that while monetary policy can be supportive of growth in the short-term, higher trend growth requires a range of economic reforms including faster public infrastructure spending, better quality education and more effective dispute resolution mechanisms in the labour market. It is not within the realm of monetary policy alone to deal with the myriad of challenges confronting the economy. Unrealistic expectations or demanding too much from monetary policy is likely to end in a loss of policy credibility. At the same time, monetary policy should be as supportive of growth as is possible, inflation permitting. Indeed our monetary policy has remained highly accommodative, notwithstanding significant price pressures.

This year saw the first significant banking failure in almost a decade. The South African Reserve Bank intervened to manage the failure of African Bank, first through requesting the Minister of Finance to place African Bank under curatorship and secondly by putting in place a package of measures that are in keeping with the Financial Stability Board's key attributes, aimed at enabling the institution to continue to operate and to serve its customers, which it is continuing to do.

The Reserve Bank acted quickly to prevent contagion to the rest of the banking sector. Not only is South Africa's banking sector healthy, but all the major players are liquid and well capitalised. So far, we have not seen any significant adverse effects of the difficulties at African Bank on the broader financial markets or the economy, though we remain vigilant.

The challenges posed by African Bank's failure raises several policy questions that are of relevance for many countries in the world. How do we define financial inclusion in a developing country context? For many, financial inclusion refers to the ability to access credit. While access to credit is important, surely financial inclusion should also focus on enabling poor households to accumulate assets, transact efficiently and insure against the normal risks associated with everyday life. South Africa will continue to take steps to promote financial inclusion but we will not tolerate unhealthy lending practices or excessive risk-taking in the financial sector.

The second policy challenge that African Bank has brought to the fore is the degree to which the financial sector and the banking system in particular is interconnected and inter-dependent. This is a difficult balance to strike because, from an individual bank or company perspective, inter-dependencies reduce risk. However, from a system perspective, inter-dependencies increase risk. We all have much to learn about how we promote financial deepening and integration but protect the system against systemic risk.

As a reflection of our commitment to enhance a sound and effective financial sector, and learn from the global crisis, South Africa's adoption of a "twin peaks" regulatory framework will be formalised in the course of the next year, with legislation setting out the roles and responsibilities of all parties in the financial regulatory architecture. This legislation draws on both international and our own experiences, creating a Prudential Authority with the Bank, and a Market Conduct Authority that will take the place of the Financial Services Board.

In conclusion, the world economy is in a better position than a year ago, but the crisis is not over and significant risks remain. Global trade is rising, after stagnating for several years. Notwithstanding a withdrawal of liquidity in some advanced economies, financial flows continue to impact on emerging markets. 2014 flows to South Africa have been volatile and at an elevated price, with September seeing significant outflows such that year to date flows are negative at some R22bn. Experts are beginning to talk about prices of several commodities reaching the bottom, with the potential for a period of either stability or modest price increases going forward. These trends should support growth going forward in sub-Saharan Africa, particularly given the significant discoveries of oil and gas. On the other hand, geopolitical factors continue to affect growth in Europe, the Middle East and North Africa. The keenly contested Scottish independence referendum also affected market sentiment, and the political ramifications will not simply disappear even though the outcome was a victory for the "no" vote. The Ebola outbreak in West Africa will affect regional GDP growth, trade and air travel. In many countries around the world, job losses incurred during the financial crisis are likely to turn into permanent decreases in productive capacity. Global unemployment and particularly youth unemployment is still unacceptably high in almost every region in the world.

South Africa remains concerned that, whereas the world came together in 2008–09 in a coordinated response to the global financial crisis, policy today is more inwardly focused and disparate, rather than coordinated and coherent. The world economy still needs a high level of cooperation and partnership in order to complete the recovery process. We still need joint activity to ensure faster growth.

Our responsibilities, as leaders of our respective countries, are not just price or financial stability. While these elements are important, our collective objective is for higher economic growth, shared prosperity, greater opportunities and a better life for all our citizens. And given the prevailing economic outlook and risks, it is incumbent on all of us to get our own houses in order, take the tough decisions, make the necessary trade-offs and work together. The effort this year in the G20, under Australia's able presidency, to increase collective growth by an additional 2 percentage points by 2018 is a good example of the kinds of measures that we need.

Honourable guests, the South African Reserve Bank is proud of our track record in engaging with our citizens and other stakeholders, both local and foreign. We will continue to deepen our engagements in order to be part of a global movement for shared prosperity. You know, but we wish to repeat, that we are open to interaction and conversation with you and look forward to continued collaboration and cooperation as we work together for a shared future.

As all of you know, my term as governor ends in a few weeks' time. I would like to thank the diplomatic community for the support and cooperation that you have given, not just to me, but to the South African Reserve Bank and to South Africa in general. This singular honour, to serve as governor of the South African Reserve Bank, has enabled me to serve my country, and form friendships and ties across the world; ties that I will maintain long into the future.

Thank you.