Lesetja Kganyago: Overview of the South African economy

Address by Mr Lesetja Kganyago, Governor of the South African Reserve Bank, at the 95th annual ordinary general meeting of shareholders, Pretoria, 31 July 2015.

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The Bank has come through yet another difficult year, and the coming year looks no less challenging. At the global level, the past year has been dominated by the expectation of a sustained recovery in the United States and United Kingdom. Despite negative growth in the US during the first quarter of this year, partly due to adverse weather conditions, recent positive labour market trends appear to have remained resilient, and there are increased signs that the recovery will be sustained.

Although growth in the Eurozone remains relatively weak, it has emerged from a recession and there appear to be some positive responses to the significant monetary policy stimulus implemented by the European Central Bank since earlier this year. The past few weeks were dominated by renewed concerns about the sustainability of Greek debt and the possibility of Greece leaving the eurozone. The near term risks from this crisis appear to have been averted for now, but the longer term sustainability of the Greek debt burden remains a concern. Growth in Japan remains positive but very slow.

The outlook for emerging markets deteriorated over the past year, with negative growth rates in both Brazil and Russia, and a slowdown in China, as the economy rebalanced away from domestic investment towards consumption. While there has been a general expectation that China would at worst experience a soft landing, i.e. growth of just under 7,0 per cent, recent developments including the bursting of the Chinese equity market bubble, and systemic risks to the financial markets and the property market, increase the downside risks to the outlook. The growth moderation has already contributed to the persistent decline in commodity prices that began in 2011, and accelerated in the past two months. The adverse effect on South Africa's terms of trade was ameliorated somewhat by the sharp decline in international oil prices that started in the middle of last year. Although growth in African economies remains relatively robust, oil and other commodity producers face an increasingly difficult outlook.

Uncertainty regarding the pace and timing of US policy interest rate normalisation continued to dominate global financial markets and the pattern of global capital flows. The changing outlook regarding domestic US growth, labour market trends and inflation caused a great deal of volatility in financial markets. Although an increase in the policy rate is expected sometime this year, the exact timing is still uncertain, as is the pace and timing of future increases. Monetary policy in the UK is also expected to be tightened later this year or early next year. By contrast, monetary policy in Japan and the eurozone remains highly accommodative, and is expected to remain so for some time.

Changing expectations with respect to monetary policy stances in the advanced economies are likely to keep emerging-market currencies relatively volatile, as capital flows respond to these developments. The rand was particularly vulnerable to changes in risk perceptions, having depreciated by about 10 per cent on a trade-weighted basis during the financial year under review. Since April 2015 it has depreciated by a further 4,5 per cent. However, domestic factors also contributed to this depreciating trend. These included the persistently wide current-account deficit of around 5 per cent of GDP, the strained labour relations environment, and the weak growth outlook.

The past financial year was particularly difficult for the domestic economy, which had to contend with a protracted strike in the platinum sector followed by a strike by metal workers. The downward pressure on growth was exacerbated by the resumption of regular electricity load-shedding by Eskom, which is expected to continue for some time.

The outlook for the economy remains subdued following a growth rate of 1,5 per cent in 2014. The Bank forecasts economic growth of 2,0 and 2,1 per cent in 2015 and 2016, rising to 2,6 per cent in 2017 when the electricity supply constraint is expected to ease to some extent. Growth in private-sector gross fixed capital formation remains weak but it improved somewhat in the second half of 2014 and the first quarter of 2015, following a contraction in the first half last year. Household consumption expenditure grew by less than 2 per cent amid low credit extension to households, weak employment growth and a sharp decline in consumer confidence.

Headline inflation, which had exceeded the target for five consecutive months during 2014, returned to within the target range of 3 to 6 per cent in September and has remained within the range since then. In the wake of the international oil price decline, inflation reached a low of 3,9 per cent in February 2015 and has been increasing steadily since then, and measured 4,7 per cent in June. The Bank expects inflation to temporarily breach the upper end of the target range during the first two quarters of 2016, with upside risks and pressures from the weaker exchange rate as well as food and electricity prices. Wage settlements in excess of inflation and productivity increases are expected to contribute to the persistence of inflation at the upper end of the range. Core inflation is expected to remain within the target but uncomfortably close to the upper end of the range.

Monetary policy had to contend with the continued dilemma of trying to balance rising risks to the inflation outlook (driven to a large extent by supply-side shocks) and a weak economy. A tightening monetary policy cycle commenced in January 2014 with a 50 basis point increase, followed by a further 25 basis point increase in July 2014. This move was prompted by a combination of rising inflation risks and the need to normalise the real policy rate, which had been negative for some time. The lower oil price also allowed for a pause in this cycle. The Bank's Monetary Policy Committee (MPC) emphasised the likely moderate nature of the cycle given the negative output gap, and that further moves would be highly data-dependent. In its most recent meeting earlier this month, the MPC decided to continue on its path of gradual policy rate normalisation, amid continued upside risks to the inflation outlook. Consequently, the repurchase rate was increased by 25 basis points to 6,0 per cent per annum. The Bank remains committed to achieving its primary mandate of price stability but will continue to conduct policy in a manner that is sensitive to the fragile state of the domestic economy.

Progress towards operationalising the financial stability mandate of the Bank continued in line with the Twin Peaks Regulatory Model which expands the responsibility of the Bank for prudential regulation and supervision beyond banking, and locates the Prudential Authority within the Bank. The Financial Sector Regulation Bill, which is expected to be tabled in Parliament during 2015, assigns to the Bank the responsibility to maintain, promote and enhance financial stability. The Bill gives effect to the policy framework for macroprudential regulation and supervision and further provides for interaction and coordination between the Prudential Authority within the Bank and other financial sector regulators. Once passed, the Bill is expected to have significant resource and personnel implications for the Bank.

In the year under review, the Bank continued to develop its capacity to oversee and monitor the broader financial sector with the adoption of a macroprudential surveillance approach.

At the microprudential level, the past year saw the first significant bank failure in South Africa in over a decade when African Bank Limited was placed under curatorship. In cooperation with National Treasury, the Bank and the private sector, the issue was resolved and prevented systemic spillovers, which includes the application of bail-in provisions. This was in line with the *Key attributes of effective resolution regimes* of the Financial Stability Board, which South Africa has undertaken to adhere to as a G-20 member country. African Bank Limited remains under curatorship and, once it is restructured, it is anticipated that the resulting "Good Bank" will be relisted in the foreseeable future.

Let me now turn to the Annual Report.

The Bank remains committed to complying with best practice in terms of integrated reporting, insofar as it is practical for a central bank to do so, taking into account the overriding legislation and confidentiality requirements. The *2014/15 Annual Report* reflects a holistic account of all relevant and material financial and non-financial information, which will enable stakeholders to evaluate the performance and impact of the Bank's operations and the implementation of its mandate. We have again this year enhanced the look and feel of the printed annual report and produced an interactive and easy to navigate HTML version on the website. We hope that you have enjoyed reading the report.

I am pleased to report that, having made losses in the previous five financial years, the Bank has returned to profitability. I should emphasise, however, that the Bank does not have a profit-maximising objective and that its operations are conducted in the broader interests of the country, in pursuit of its mandate and responsibilities. The Group recorded an after-tax profit of R0,63 billion compared with a loss of R1,3 billion in the previous financial year. This improvement in the financial position of the Bank was attributable mainly to unrealised profits due to declining global bond yields and the depreciation of the rand against major currencies, which increased the rand value of the interest earned from investing the country's foreign-exchange reserves. Operating cost increases were attributable mainly to the higher cost of producing new currency, higher staffing costs, as well as the change in the actuarial assumptions related to post-retirement benefits.

This year the shareholders' Roadshow was held only in Pretoria on 14 July, as there were no timeous confirmations received from shareholders who wished to participate in the event at the Cape Town and Durban branches via a video conference facility. Unfortunately, we have found that the interest from shareholders in attending the Roadshow meetings has diminished over time and accordingly we have decided that we will no longer hold the Roadshow events prior to the AGM each year. However, I encourage shareholders to communicate with the Bank via email or post when necessary and we will always respond to your enquiries and the Bank will continue to correspond with the shareholders where there are significant developments which would be relevant to them. In addition, the Bank holds Monetary Policy Forums twice annually in Pretoria and in various centres around the country and you are welcome to attend those meetings.